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Supreme Court, U.S.
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In the
SUPREME COURT OF THE UNITED STATES
October Term, 1999

Jeffrey A. Glassman and Mary K. Glassman,
Petitioner

v.

Commissioner of Internal Revenue,
Respondent

On Petition for a Writ of Certiorari to the California Supreme Court

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PETITION FOR WRIT OF CERTIORARI

ROBERT GLASSER
(*Counsel of Record*)
GLASSER AND SMITH, APC
901 Dove St., Suite 299
Newport Beach, California 92660
(949) 752-2727

Attorneys for Petitioner

164pp

QUESTIONS PRESENTED

1. After incurring legal expenses, is a Taxpayer empowered to determine the tax consequences of those expenses by where on her Form 1040 she reports the income from the asset subject of the litigation, or does the Origin of the Claim Test apply to bar both the primary purpose of the Taxpayer or the tax consequences of the litigation tests.

2. In characterizing the tax consequences of legal expenses incurred to obtain pension payments, either as a capital, basis-increasing expense, or as an ordinary expense, subject to the alternative minimum tax, may the IRS and the below courts nullify the Origin of the Claim Test this Court originated in *United States v. Gilmore* (1963) 372 U.S. 39 (accord *United States v. Hilton Hotels* (1970) 397 U.S. 580; *Woodward v. Commissioner* (1970) 397 U.S. 572) by assuming that all pension distributions are, as a matter of law, ordinary income, regardless that each distribution includes partial return of its purchase cost, and that the pension was bought with after-tax dollars, voluntarily, and not with employment services.

PARTIES

The parties are as stated in the caption:

Jeffrey A. Glassman and Mary K. Glassman, Petitioner/Taxpayer

Commissioner of Internal Revenue, Respondent

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PETITION FOR A WRIT OF CERTIORARI

Petitioners, Jeffrey A. and Mary K Glassman, (hereinafter "Petitioners" or "Taxpayer") respectfully pray that a writ of certiorari issue to review the final disposition of the Ninth Circuit Court of Appeal, denying rehearing by Order on December 2, 1999.

OPINIONS AND ORDERS

The Tax Court Memorandum in *Jeffrey A. Glassman and Mary K. Glassman v. Commissioner of Internal Revenue* is published at TCM 1997-497, 74 TCM 1106. For the reasons stated therein, the Ninth Circuit Court of Appeals affirmed on October 19, 1999. The Ninth Circuit Memorandum affirming the published Memorandum of the Tax Court is reprinted at App. 1, Appendix A. Tax Court Memorandum 1997-497, is Appendix B reprinted at App. 2. The Ninth Circuit denied the petition for rehearing and the suggestion for rehearing *en banc* on December 2, 1999, which Order is Appendix C, reprinted at page App. 7.

STATEMENT OF JURISDICTION

The jurisdiction of this Court is conveyed by 28 U.S.C. § 1254(1).

STATUTES & REGULATIONSApplicable parts of the Internal Revenue Code, Title 26, United States Code and ERISA, Labor Code, Title 29, are reprinted in the Appendix, and listed in the Table of Contents.

STATEMENT OF THE CASESUMMARY OF THE CASE

Taxpayers sought a tax refund for 1992[1] This followed an Internal Revenue Service ("IRS") determination by the that legal fees[2] to enforce a Qualified Domestic Relations Order[3] to obtain a pension asset were fees not to recover a capital asset, and not added to the $11,734.60[4] 1992 purchase basis of the asset, but were fees to recover ordinary income, hence subject to the Alternative Minimum Tax ("AMT"). On October 2, 1995, the IRS gave Notice of Deficiency. Stipulation of Settled Issues, CR 8, Ex. 2-B. Taxpayers filed for review in the United States Tax Court pursuant to its jurisdiction under 26 U.S.C. § 7429.

The Tax Court ruling for the IRS is published at TCM 1997-497, 74 TCM 1106[5]. The Ninth Circuit Court of Appeals affirmed "for the reasons stated in the tax court opinion" (App. 1, Appendix A). The Tax Court said,

> Generally, expenses must be capitalized if they are paid to acquire, dispose, defend, perfect title to, or improve property. {Citations.) Petitioners contend

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[1]They paid, with interest, a deficiency of $17,049.92. See Exhibit 2-B ("Ex. 2-B"), attached to Stipulated Facts. The Stipulated Facts are document number 8 in the Clerk's Record ("CR") on Appeal. The Record contains a sequential number for each document, assigned by the Clerk of the Tax, and delivered to the Ninth Circuit Court of Appeals. Documents in the Clerk's Record are designated herein and in the briefs of the Commissioner with the prefix CR and the number. Stipulated Facts are thus at CR 8, and each Fact is designated by its paragraph number and the prefix "Stip."

[2]Of $84,863.00 in 1992. Stip. 20.

[3] Stips. 10-13.

[4]Comprising gross pension income of $119,783.64 less taxable pension income of $108,050.04. Taxpayers 1992 Form 1040, Ex. 1-A; also Stipulated Facts 20, 21. The difference is the cost of acquisition reported by the Hughes Non-Bargaining Retirement Plan, box 5, Forms 1099-R, and is the sum of $8,743.20, $2,774.04, and $216.36. Ex. 1-A, last four pages,.

[5] Reprinted at App. 2, Appendix B. It is CR 16.

that, under the origin of the claim test, their payments are capital expenditures. Because this case is appealable to the Court of Appeals for the Ninth Circuit, we must apply the Ninth Circuit's version of the origin of the {1108} claim test. (Citation.) In *Keller St. Dev. Co. v. Commissioner*, 688 F.2d 675, 678 (9th Cir. 1982), affg. T.C. Memo. 1978-350, the Court of Appeals for the Ninth Circuit stated that the origin of the claim test is a 2-step process. Cf. *Boagni v. Commissioner*, 59 T.C. 708 (1973) (applying a list of factors)[6].

The first step requires us to identify the transaction or event from which the claim originated (i.e., the event that prompted the cause of action and formed the basis of the suit). *Keller St. Dev. Co. v. Commissioner, supra* at 681. Mrs. Glassman's claim against the Hughes Plan originated from the administrator's calculation and payment of her community share of retirement benefits. The administrator's actions prompted Mrs. Glassman to file her claim and formed the basis of her cause of action.

The second step requires us to characterize the transaction that we identified in the first step. *Id.* at 678. Respondent contends that the taxable portion of the income stream from the Hughes Plan is ordinary income. See secs. 61(a)(11), 72, 402(a); *Eatinger v. Commissioner*, T.C. Memo. 1990-310. Indeed, petitioners consistently reported the taxable portion of all payments from the plan as ordinary income. We conclude that Mrs. Glassman's claim relates to the calculation of benefits under the Hughes Plan, not to a "capital transaction" (e.g., the acquisition, disposition, defense, or protection of title to

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[6]Disapproved in *Keller Street Development Co. v. Commissioner* (9th Cir. 1982) 688 F.2d 675. 680 See Argument, *infra*.

> property). Therefore, petitioners' expenditures are not capital expenditures. 74 TCM 1106, 1107-1108.

As shown in this petition, this reasoning fails on each point. None honor the Origin of the Claim Test which this Court set forth in *United States v. Gilmore* (1963) 372 U.S. 39 and *Woodward v. Commissioner* (1970) 397 U.S. 572 to determine the proper tax treatment of legal fees. The Tax Court publication forever establishes by law what this Court taught was a factual question. It relies not on the stipulated or other facts in the record.

The Circuit Court of Appeals' approved Tax Court opinion looks not to the originating persona, business, or capital activity of the Taxpayer. Rather, the subject opinion instructs reliance is on the tax consequences of the litigation and the purpose Taxpayers might express by how they fill in their tax returns. These are methods *Woodward* expressly disapproved.

The decision of the Ninth Circuit to affirm the Tax Court Memorandum is error as a matter of law, and is a bad seed precedent contrary to and certain to erode the instructions of this Court in the Origin of the Claim Test.

FACTUAL HISTORY OF THE CASE

The relevant facts in this case are by stipulation or are uncontested and in the record below.

Taxpayer-wife was awarded an interest in the pension benefits her former husband had earned in the Hughes (Aircraft Company) Non-Bargaining Retirement Plan, which was her sole and separate property. Stip. 9.

The requirements to obtain pension rights are in Plan ¶ 2.3. Ex. 3-C, pp. 20-21. They show that the cost of these pension rights is paid through voluntary payroll deductions from net income. No personal services are required. The participant's duties and obligations to the company are unaffected whether he joins the pension plan or not. The former husband of Taxpayer-wife made joined the plan and bought pension rights by his contributions from his net pay.

Stip. 5. These are the employee costs to acquire the pension as shown at 26 U.S.C. §72(b). The non-taxable pension distributions constituted return of the employee contributions. Stip. 11.

Taxpayer-wife obtained a Qualified Domestic Relations Order ("QDRO") for the Hughes Plan to pay her interest to her. Stip. 10. The QDRO reflects petitioner's irrevocable election, pursuant to the terms of the Hughes Plan, to receive such benefit payments pursuant to the Period Certain Annuity for a five year period. Stip. 11.

A dispute between Taxpayer-wife and the Plan arose over what were her pension rights to the amount and timing of her benefits. Sip. 13. This resulted in an Order to Show Cause ("OSC") to compel payments pursuant to the QDRO. Stip. 13. "To the extent these legal expenses are determined not to be capitalized expenditures, they are allowable as ordinary and necessary expenses paid for the production or collection of income." Stip. 19.

On February 28, 1992, the Superior Court of California heard the OSC, and on May 3, 1992 found for the Hughes Plan . Stip. 15. On June 26, 1992, Taxpayer-wife filed an appeal with the California Court of Appeal. Stip. 16. The subsequent history of the underlying case is not material to the tax issue in 1992.[7]

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[7] On July 24, 1996 the Court of Appeal reversed. Stip. 18; see In re Marriage of Oddino (1996) 48 Cal.App.4th 965, Ex. 10-J. The Plan joined by the United States Department of Labor petitioned the California Supreme Court for review on the grounds that state courts do not have jurisdiction to decide a QDRO matter, and to reverse the appellate decision that the Plan's early retirement benefit was not an employer subsidy. The State Supreme Court in *In re Marriage of Oddino* (1997) 16 Cal.4th 67 (cert. denied) found as follows. (1) State courts have concurrent jurisdiction. (2) The Plan's early retirement benefit do contain an employer subsidy, so that pursuant to 29 U.S.C. § 1056 (d)(3)(E)(i)(II) a QDRO could not order the Plan to calculate the amount to be paid an alternate payee as a percentage of the that early retirement benefit before the employee-spouse is eligible to receive it. And (3) making no decision as to the amount or timing of the benefits due Petitioner/Taxpayer-Wife,

THE LAW OF THE CASE

The courts and all parties agreed that the Origin of the Claim Test is controlling. 74 TCM, *supra*, 1107; 9th IRS RESP, 19.

Origin of the Claim Test

The Ninth Circuit summarized the Origin of the Claim Test thusly:

> B. Origin of the Claim
>
> Characterization of a transaction for taxation is a two step process. The initial step is to discover the origin of the claim from which the tax dispute arose. This attribution determination is critical to proper tax characterization because of the inherently factual nature of taxation. Once a transaction is placed in its proper context, the nature of that transaction becomes discernible, and its tax character may be identified. Thus, the second step, the actual tax characterization, is dependent upon the proper resolution of the preliminary attribution question.
>
> Attribution through the "origin of the claim" test was first explained by the Supreme Court in *United States v. Gilmore*, 372 U.S. 39, 83 S.Ct. 623, 9 L.Ed.2d 570 (1963), and its companion case, *United States v. Patrick*, 372 U.S. 53, 83 S.Ct. 618, 9 L.Ed.2d 580 (1968). [¶]
>
> Relying on *Lykes v. United States*, 343 U.S. 118, 72 S.Ct. 585, 96 L.Ed. 791 (1952), the Court rejected the notion that the attribution process is based on the consequences to the taxpayer if he fails in his defense of a legal action. *Gilmore*, 372 U.S. at 43-44,

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retained jurisdiction for her to modify and recalculate her QDRO. A modified QDRO for the full amount and timing of benefits as intended by the parties in their original QDRO is still available, and filing is imminent.

> 46-48, 83 S.Ct. at 627-28. In other words, the Court rejected the notion that attribution is a forward-looking process. It held instead that "the characterization, as 'business' or 'personal,' of the litigation costs of resisting a claim depends on whether or not the claim *arises in connection with* the taxpayer's profit-seeking activities. It does not depend on the *consequences* that might result ... from a failure to defeat the claim ...." *Gilmore*, 372 U.S. at 48, 83 S.Ct. at 628 (emphasis in original).
>
> Thus, as noted earlier, the characterization process has a preliminary step: the cost (or income) at issue must be attributable to a business activity to be a business expense, a personal activity to be a personal expense, or a capital activity to be an adjustment in the value of the capital asset. Emphasis added, *Keller Street Development Co. v. Commissioner* (9th Cir. 1982) 688 F.2d 675, 678

Authorities re Ordinary Income v Capital Asset

The Tax Court cites four authorities for the proposition that "the income stream from the Hughes Plan is ordinary income." These are secs. 61(a)(11), 72, 402(a) and *Eatinger v. Commissioner*. Of these, only § 72 refers to "ordinary income", or even uses the word ordinary in any sense. The court linked these authorities to Respondent's contentions stated in the IRS Opening Brief to the Tax Court ("IRS OB"):

> The legal expenses in issue were incurred in relation to a dispute as to the calculation of petitioner's community share of her former husband's pension benefits under the Hughes Plan. The gist of petitioner's claim against the Hughes Plan is that she is owed more money and the purpose of her civil action is to collect it. Accordingly, the origin and character of petitioner's claim lies not in a capital asset but in a "right to receive a future income stream from [her former husband's] employer,"

> which is taxable as ordinary income, I.R.C. §§61(a)(11), 72 and 402(a).[fn1] *Eatinger v. Commissioner*, T.C. Memo 1990-310; Cf. *Alexander v. United States*, 72 F.3d 938, 944 (1st Cir. 1995), aff'g 69 T.C. Memo 1995-51 ("Because the damages Taxpayer received are essentially a substitute for the salary and benefits he would have received under the employment contract, they are fully included as ordinary income in Taxpayer's gross income under Section 61, without regard to whether Taxpayer's employment contracts constituted 'property' or 'intangible assets.'").
>
> [fn1] Pension income is clearly includable as ordinary income pursuant to I.R.C. §61(a)(11). Further, I.R.C. §§402(a) and 72 set forth the manner and amount in which pension income must be reported. Petitioner, as an alternate payee treated as a "distributee" under I.R.C. §402(e)(1)(A), is subject to the reporting and taxing provisions of sections 61(a), 72 and 402(a). Emphasis added, IRS OB,11, 12

The courts below relied on and implied the accuracy of the legal assertions the IRS made. Criticisms of each authority the IRS cites now follows:

IRC Section 402(a) Taxability of beneficiary of employees' trust

The IRS reference to §402(a) is immaterial. It makes distributions from a tax-exempt qualified plan to a distributee taxable to the distributee. It does not address whether pension payments are ordinary income or proceeds from the sale or disposition of a capital asset, taxable in part and return of cost in part.

IRC Section 61. Gross income defined

Section 61 only defines gross income. It requires additional restrictions and factual information to explicate

ordinary income. The statute says,

> (a) General definition
>
> Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: [¶] ... (9) Annuities; [¶] ... (11) Pensions... .

The IRS clarified its reliance on § 61 in its Response Brief to the Ninth Circuit ("9th IRS RESP"), as discussed in Argument, *infra.* It added *Stanford v. Commissioner* (9th Cir. 1961) 297 F.2d 298, *Alexander*, § 64, and § 1221. What these cases say relative to the IRS citations follows.

IRC Section 64. Ordinary income defined

The courts below do not account for IRC § 64, which defines ordinary income.

> For purposes of this subtitle, the term "ordinary income" includes any gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b) ["Property used in the trade or business and involuntary conversions"]. Emphasis added.

IRC Section 1221. Capital asset defined.

> For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include-
>
> (1) ... property ... in the inventory of the taxpayer ... or property ... for sale ...;
>
> (2) property ... subject to ... depreciation ... or real property ...;
>
> (3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property ... ;
>
> (4) accounts or notes receivable ...;
>
> (5) a publication of the United States ... .

A pension is not one of the five exclusions, hence it is a

capital asset if it is a property. It is a property, and therefore a capital asset, unless it is deferred compensation for employment.

Stanford

The IRS citation from *Stanford* states

> All income from personal services, including pensions, must be regarded as ordinary income. Title 26 U.S.C.A. 61. And no provision for treating such income as capital gain under any circumstances is found any where in the code. *See* Title 26 U.S.C.A. §§ 1221, 1222. *Id.*, 304. Emphasis added.

This is conditional authority for section 61 to define ordinary income. The condition is that the pension income be compensation for personal services. This condition was a fact already established in *Stanford*:

> [T]he payment represented a pension paid to petitioners for services previously rendered by the taxpayer to [the corporation]. . . . *Stanford*, 299.

Alexander

What the IRS paraphrased from *Alexander* actually says

> [W]hat Taxpayer fought for, and received, is merely a substitute payment for the compensation and retirement benefits due him under his express and implied employment contracts. Because his salary and benefits would have been taxed as ordinary income without any offsetting basis if received in the ordinary course under Taxpayer's employment contract, the "substitute" payments can be treated no differently. ... [¶]
>
> ... As the Tax Court correctly noted, assuming the settlement was a "cancellation" of Taxpayer's rights, it does not necessarily follow that the settlement constituted a "disposition" of "property" warranting an offsetting of basis. *See Herbert's Estate v.*

> *Commissioner*, 139 F.2d 756 (3d Cir. 1943) ... . More importantly, to permit Taxpayer to offset his "cost of disposition" or basis -- the Legal Fee -- would be fundamentally inapposite in light of the controlling fact that the settlement proceeds are clearly in the nature of compensation as Young's employee.[fn9]
>
> [fn9] One might intuitively argue that some sort of "basis" should be recognized when one has to litigate to receive one's due compensation. The fact remains, however, that the Code simply does not provide for the offsetting of basis ... except in limited cases involving capital assets. Emphasis added, *Alexander*, 943.

Herbert's Estate says of "disposition",

> [D]oes one who acquires a claim against a third person make a disposition of it when the third person pays it? The dictionary definition of "disposition" is the meaning one usually attributes to the word. It is "The getting rid, or making over, of anything; relinquishment;". ... The rule of construction that the ordinary or settled meaning of a word will prevail, in the absence of an indication that it is to be construed otherwise, needs no citation. *Id.*, 758

Alexander, too, relies on a factual showing that the pension was part of an employment contract and that it had no offsetting basis.

The IRS agrees with *Alexander* on the role of the basis in taxation:

> [I]t is an established principle of taxation that capital expenditures are added to the basis of the capital asset to which such expenditures relate and are "taken into account for tax purposes ... by reducing the capital gain (or increasing the loss) when the asset is sold [or otherwise disposed]." [Footnote.] *Woodward*, 397 U.S. at 575; I.R.C.

> §§1001 [Determination of amount of and recognition of gain or loss] and 1016 [Adjustments to basis]. IRS OB, 12.

26 U.S.C. § 72. Annuities; certain proceeds of endowment and life insurance contracts

The IRS, *supra*, says Section "72 set[s] forth the manner and amount in which pension income must be reported", implying an equivalence between annuities and pensions. Also, Form 1040 (see Ex. 1-A) treats pensions and annuities equivalently on the same lines.

Section 72 provides at subsection (b) that any investment in the pension is not included in the gross income, not the ordinary income.

As shown below, the Form 1040 provides for reporting "Total pensions and annuities" at line 17a and the "Taxable amount" at line 17b. The Form 1099-R in relevant part refers to the "Gross distribution", "Taxable amount", and "Employee contributions". See Ex. 1-A, last four pages. Equating these expressions in the statutes and forms shows that the "Total pension received" corresponds to "gross distribution", and the "Taxable amount" of pensions is again "Gross income", but not necessarily ordinary income.

Section 72(u) establishes an exception, however, and makes certain annuity income ordinary income. It says,

> (u) Treatment of annuity contracts not held by natural persons
>
> (1) In general [¶] If any annuity contract is held by a person who is not a natural person - ... [¶] ... the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the owner during such taxable year. Emphasis added.

If all pension or annuity income is treated as ordinary income by law, then § 72(u) is superfluous.

26 U.S.C. § 1001. Determination of amount of and

recognition of gain or loss

(a) Computation of gain or loss

The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided... for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

...

(d) Installment sales

Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

ERISA

One facet of the dispute below was whether the pension income in question was from an interest in an investment trust, or compensation from the employer. The law distinguishes the two.

The Plan is an ERISA-qualified Plan pursuant to IRC §401, and tax-exempt under § 501. Stip. 6. These sections provide that the corpus of the trust may not be diverted or used for any purpose other than the exclusive benefit of employees or beneficiaries prior to satisfaction of all such liabilities. §401(a)(2), §501(c)(17)(A)(i). ERISA further provides that the Plan shall be administered solely in the interests of participants and beneficiaries, and according to the terms of the Plan. 29 U.S.C. § 1104. Thus a bright line lies between the corpus of the trust and the administration of the Plan, on the one hand, and the assets and governance of the employer on the other.

The distinction extends to ERISA definitions. *Plan* and *employer* are different entities. 29 U.S.C. §§1002(2) and (5).

TAX FORMS

The 1992 Form 1040 (Ex. 1-A) contains the following lines for Taxpayers to report income:

7 Wages, salaries, tips, etc. Attach Form(s) W-2

8 a Taxable interest income. Attach Schedule B if over $400

b Tax-exempt interest income (see page 15). DON'T include on line 8a

9 Dividend income Attach Schedule B if over $400

10 Taxable refunds, credits, or offsets of state and local income taxes from worksheet on page 16

11 Alimony received

12 Business income or (loss). Attach Schedule C or C-EZ

13 Capital gain or (loss). Attach Schedule D

14 Capital gain distributions not reported on line 13 (see page 15)

15 Other gains or (losses). Attach Form 4797

16 a Total IRA distributions

b Taxable amount (see page 16)

17 a Total pensions and annuities

b Taxable amount (see page 16)

18 Rents, royalties, partnerships, estates, trusts, etc. Attach Schedule E

19 Farm income or (loss). Attach Schedule F

20 Unemployment compensation (see page 11)

21 a Social security benefits

b Taxable amount (see page 17)

22 Other income. List type and amount—see page 18

23 Add the amounts in the far right column for lines 7 through 22. This is your **total income**.

At line 17b is a reference to page 16 of the Form 1040 instructions, which states,

> Fully Taxable Pensions and Annuities
>
> If your pension or annuity is fully taxable, enter it on line 17b; do not make an entry on line 17a. Your

pension or annuity payments are fully taxable if either of the following applies:

1. You did not contribute to the cost of your pension or annuity, or

2. You used the 3-Year Rule and you got your entire cost back tax free before 1992.

Fully taxable pensions and annuities also include military retirement pay shown on Form 1099-R. Emphasis added.

The Form 1040 identifies none of these lines as "ordinary income". Following next on the Form after income reporting are lines for "Adjustments to Income". Lines 24-30. The difference of total income less adjustments is "Adjusted Gross Income", again not "ordinary income".

The courts below determined that Taxpayers reported their pension income as ordinary income on the IRS assertion that all amounts on all lines on the Form 1040 were ordinary income except for Schedule D (and hence line 13). The Form shows capital gains are expressly included on line 14 as well. Moreover, gains and losses in the sale of business property are reported on Form 4797, to be copied onto line 15. These latter gains or losses, too, are excluded from ordinary income.

ARGUMENT

The published and Circuit Court approved Tax Court opinion says it applied this Court's Origin of the Claim Test. Instead, it is novel authority that pension distributions are necessarily ordinary income, and thus legal expenses to obtain pension distributions are necessarily subject to the Alternative Minimum Tax. That such distributions are only ordinary income this opinion says is a matter of law, and no factual inquiry is necessary. The Test this Court originated, however, requires a factual determination of what was the originating activity of the Taxpayer, personal, business, or capital, before determining the tax treatment of the legal expenses incurred that relate to that activity.

The Tax Court opinion rests on the assumption that all pensions are deferred compensation for employment, and that a voluntarily purchased pension by payroll deduction with a partial return of this purchase cost in each and every distribution payment cannot constitute the pension as a capital asset.

The assumption is further belied by the Stipulated Fact that the assignment to the Taxpayer of her marital property share in the pension via QDRO did not cause her to become an employee whose pension was deferred compensation for her employment services. The activity of the Taxpayer and that of her former spouse was in joining a pension plan and the purchase of its promised benefits with after-tax dollar, voluntary deductions from net pay. The question is whether such a purchase for profit created a pension property that was a capital asset, or was somehow the purchase of deferred compensation.

The nature of the taxpayer activity is the origin, the legal activity related to it is the claim, and the legal expenses to pursue or defend the claim related to the activity has tax consequences of the same character and nature as the originating activity: personal, business, capital. Neither the purpose of the litigation nor the tax consequences of the

result of the litigation go to the characterization whether the legal expenses are capitalized. If legal fees are incurred in an action related to a capital asset, the legal fees are capitalized.

Notwithstanding that the pension was paid from the Plan trust and was not compensation for employment, the courts below relied upon an either expressly or impliedly agreed with the IRS assertion:

> The legal expenses in issue were incurred in relation to a dispute as to the calculation of petitioner's community share of her former husband's pension benefits under the Hughes Plan. The gist of petitioner's claim against the Hughes Plan is that she is owed more money and the purpose of her civil action is to collect it. Accordingly, the origin and character of petitioner's claim lies not in a capital asset but in a "right to receive a future income stream from [her former husband's] employer," which is {11} taxable as ordinary income, I.R.C. §§61(a)(11), 72 and 402(a).[1] *Eatinger v. Commissioner*, T.C. Memo 1990-310; Cf. *Alexander v. United States*, 72 F.3d 938, 944 (1st Cir. 1995), aff'g 69 T.C. Memo 1995-51 ("Because the damages Taxpayer received are essentially a substitute for the salary and benefits he would have received under the employment contract, they are fully included as ordinary income in Taxpayer's gross income under Section 61, without regard to whether Taxpayer's employment contracts constituted 'property' or 'intangible assets.'"). Emphasis added, IRS OB, pp. 11-12.

The passage from *Eatinger* which the Commissioner cites actually says:

> A military retirement pension, like [some] other pensions, is simply a right to receive a future income stream from the retiree's employer. *Eatinger*, p. 956.

Thus the courts below created a false authority for all

pensions to be income from the employer, when the original only applied to military pensions and some others, but certainly not all pensions. For example, a privately purchased, commercial annuity is also a pension, involves no employer, and is not deferred compensation. Such an annuity is an asset, purchased and held for profit, a capital asset.

Just as the Commissioner and the courts below ignored the restriction of *Eatinger* to military pensions, they ignored the restricted application of *Alexander* just to pension benefits that were deferred compensation "received under the employment contract".

Then, the Tax Court accepted that there was no disposition of property in the distribution of the subject pension. The IRS said:

> There is no evidence in the record to support a finding that all or a portion of petitioner's rights in the Hughes Plan was sold or otherwise disposed of in taxable year 1992 or in any other year. [Footnote omitted.] Nor could petitioner have sold or disposed of her provisions set forth in the Hughes Plan and imposed by ERISA. 29 U.S.C. §1056(d) (West 1985); (Stip., par. 7). IRS OB, pp. 12-13.

The Stipulated Fact (No. 7) the IRS cites says simply that any disposition of an alternate payee's right must be pursuant to a QDRO, not that any disposition is barred. Then Stipulated Fact 11 states that a disposition was indeed effected under a QDRO, causing a liquidation of her rights by payment, and as the subsequent Stipulated Facts show, culminated in a dispute and litigation. The evidence not only is in the record, but the IRS stipulated to it.

Again to the Ninth Circuit, the IRS misstated *Alexander* and *Eatinger*. In its Response Brief it said,

> [I]t is clear that in this case there has been no sale or exchange of property that was a capital asset.... Hence, the retirement benefits received by taxpayers from the Hughes Plan were ordinary income. *See*

I.R.C. § 64; *See Stanford v Commissioner*, 297 F.2d 298, 304 (9th Cir. 1961); (payments received by taxpayer were ordinary income because they were made pursuant to taxpayer's pension rights); cf. *Alexander v Commissioner*. 72 F.3d 938, 943 (1st Cir. 1995) (payment received in settlement of litigation was substitute for compensation and retirement benefits due and is therefore taxed as ordinary income)

The proposition that pension income is ordinary income is well settled, as this Court has noted:

> All income from personal services, including pensions, must be regarded as ordinary income. Title 26 U.S.C.A. 61. And no provision for treating such income as capital gain under any circumstances is found any where in the code. *See* Title 26 U.S.C.A. §§ 1221, 1222.
>
> *Stanford v Commissioner*, 297 F.2d 298, 304 (9th Cir. 1961) Taxpayers' assertion to the contrary is simply without support. Emphasis added, *id.*, 21, 22.

Following are some major discrepancies in this passage.

1. The paraphrase of *Alexander* excises the qualifying conditions on income. These distinguish the ultimate conclusion of *Alexander* from this case while validating the method. The first qualifier is the need to find an offsetting basis:

> Because his salary and benefits would have been taxed as ordinary income without any offsetting basis if received in the ordinary course under Taxpayer's employment contract, the "substitute" payments can be treated no differently. Emphasis added, *Alexander*, 943.

2. In its Opening Brief to the Tax Court, the IRS included the second qualifier for pensions to be ordinary income. Per *Alexander*, they must be "under [an] employment contract". However, to the Ninth Circuit, the IRS removed this

qualification, too.

3. The criterion for reporting a capital transaction is not that there be a "sale or exchange", but the more inclusive "sale or other disposition". *Alexander* at 943 relies on *Herbert's Estate* for a definition of disposition, which in turn says,

> [D]oes one who acquires a claim against a third person make a disposition of it when the third person pays it. The dictionary definition of "disposition" is the meaning one usually attributes to the word. It is "The getting rid, or making over, of anything; relinquishment;". ... The rule of construction that the ordinary or settled meaning of a word will prevail, in the absence of an indication that it is to be construed otherwise, needs no citation. Emphasis added, *id.*, 758

As shown by *Herbert*, and fully supported by Stipulated Facts, Taxpayer-wife had a claim against a third party, the pension plan. She could be said to have sold her rights under the usual definition of a sale, but she at least gave her rights a "making over" when she exercised her right to payment and forwent any future increases she might earn by deferring liquidation.

> A proper order for a trial court to make in these circumstances is that the nonemployee spouse is the one who has the choice as to when his or her share of the pension shall begin. This election can be made at any time after the pension is matured [footnote omitted] by motion in the trial court by {961} the nonemployee spouse and if made before actual retirement takes place constitutes an irrevocable election to give up increased payments in the future which might accrue due to increased age, longer service and a higher salary. Emphasis added, *In re Marriage of Luciano*, 960-961.

The IRS stipulated that Taxpayer-wife indeed made that irrevocable election. Stip. No. 11. The disposition is in the

record, and it was a make-over of Taxpayer-wife's rights not only to liquidate but also to do so for consideration. It altered the value of her claim. It was a liquidation of a claim for property held by a third party.

4. Whether or not there is a sale, exchange or other disposition is irrelevant to the nature of the asset.

A capital asset is simply a property which is not one of the six listed. § 1221. Even if the urging of the IRS were true that there was no evidence of a disposition, it would be irrelevant to the statutory provisions for an asset to be a capital asset, or, as the IRS concluded, the source of ordinary income.

In the IRS brief to the Ninth Circuit, the Commissioner abandoned its earlier position that no sale or disposition occurred. It now qualified that assertion to say that no sale or exchange of a capital asset occurred. From this it deduced that the asset was ordinary income! The conclusion was presumed in the premise, and is a fallacy.

The same error appeared again in the IRS briefing on *Stanford*.

5. As discussed *supra*, *Stanford* said,

> The Tax Court found as a fact that the payment represented a pension paid to petitioners for services previously rendered by the taxpayer to [the corporation]. . . . *Id*, 299.

Then on the page the IRS cites, it says

> There is substantial evidence that [the corporation] considered the payments made to taxpayer in 1955 were pursuant to taxpayer's contract with [the predecessor corporation]. and were intended to and did represent payment of taxpayer's pension for 1955. ... [¶]
>
> [A] review of the record before the Tax Court discloses abundant substantial evidence supporting the finding that the payments in 1955 represent payment of taxpayer's pension for that year.

> [¶]
>
> ... All income from personal services, including pensions, must be regarded as ordinary income. Title 26 U.S.C.A. § 61. ... [¶[.
>
> Since the amounts received by taxpayer in 1955 must be regarded as ordinary income, we next consider the question of whether such income is exempt under two statutes exempting from taxation certain income from sources outside the United States. Emphasis added, *Stanford*, 304.

As shown, the Commissioner did include the passage from *Stanford* with the "personal services" requirement. However, the IRS did not inform the court that the pension in *Glassman* was NOT compensation for services, nor was it part of any employment contract. It merely asserted it as fact to the Tax Court, notwithstanding contradictory Stipulate Facts. Then when the Tax Court erred, the IRS endorsed the error by citing it to the Ninth Circuit without comment:

> "The second step requires us to characterize the transaction or event that we identified in the first step. Id. at 678. Respondent contends that the taxable portion of the income stream from the Hughes Plan is ordinary income. See secs. 61(a) (11), 72, 402(a); *Eatinger v Commissioner*, T.C. 1990-310. Indeed, petitioners consistently reported the taxable portion of all payments from the plan as ordinary income. We conclude that Mrs. Glassman's claim relates to the calculation of benefits under the Hughes Plan, not to a "capital transaction" (e.g. the acquisition, disposition, defense, or protection of title to property). Therefore, petitioners' expenditures are not capital expenditures." Citing 74 TCM 1106, 1108. 9th IRS RESP, 10.

This passage contains the totality of the reasoning and conclusion of the Tax Court. It implies that pensions are known to be ordinary income from "61(a) (11), 72, 402(a);

Eatinger v Commissioner, T.C. 1990-310" and from how Taxpayers allegedly treated pension income on their Form 1040.

This paragraph with which the IRS prevailed before the Ninth Circuit contains the following errors of law.

1. Section 61(a) defines gross income, NOT ordinary income. Subparagraph (11) makes pensions reportable as gross income, again not ordinary income.

2. As stated by *Stanford*, Section 61(a) does define ordinary income but only when, unlike the facts in *Glassman*, the income is from personal services.

3. Section 72 provides for the treatment of pensions and annuities. Instead of supporting the conclusion of the Courts, it contradicts the conclusion. Section 72(u) provides that for a natural person, pension income is NOT to be treated as ordinary income. This is a necessary consequence of the following provision:

> If any annuity contract is held by a person who is not a natural person ... the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the owner during such taxable year. § 72(u) Treatment of annuity contracts not held by natural persons

By the principle of *expressio unius est exclusio alterius*, an exception to treat annuity income as ordinary income for other than natural persons necessarily means that the statute does not treat annuities as ordinary income for other persons, including Taxpayers here. If a pension annuity paid to a natural person is ordinary income, the reason must come from other considerations.

Furthermore, if § 61(a) did define pensions as ordinary income without more, then § 72(u) would be superfluous. In short, § 72(u) contradicts the courts' position that all pensions are ordinary income by law.

4. Section 402(a) says nothing to establish whether a pension is compensation for employment and hence ordinary income,

or whether it is a purchased annuity and hence a capital asset.
5. *Eatinger* says nothing about ordinary income, and doesn't even use the word "ordinary". The question in *Eatinger* was whether Patricia's community property interest in Col. Eatinger's military pension was an exempt transfer of property in divorce or was reportable gross income. *Eatinger* held that a military pension was gross income.
6. Lastly, the published opinion endorsed by the Ninth Circuit found how Taxpayers might report pensions on the Form 1040 determinative of the nature of the asset. The courts thus looked ahead from Taxpayer activity to the tax consequences, giving to the Taxpayer control and purpose over the nature of his assets for tax purposes.

These effects violate the teachings of this Court, from *Lykes*to *Gilmore* to *Woodward*, and plant the seed of erosion. Citing *Gilmore*, *Woodward* at 578 said

> The court rejected a test that looked to the consequences of the litigation, and did not even consider the taxpayer's motives or purposes in undertaking defense of the litigation, but rather examined the origin and character of the claim against the taxpayer, and found that the claim arose out of the personal relationship of marriage. Emphasis added.

Nor can the Taxpayer effect an artificial distinction between the true nature of an asset and how he might wish it be treated.

> The courts, not believing that congress meant all litigation expenses to be capitalized, have created the rule that such expenses are capital in nature only where the taxpayer's "primary purpose" in incurring them is to defend or perfect title. ...
>
> Taxpayers urge that this "primary purpose" test, developed in the context of cases involving the costs of defending property, should be applied to costs incurred in acquiring or disposing of property as

well. And if it is so applied, they argue, the costs here in question were properly deducted, since the legal proceedings in which they were incurred did not directly involve the question of title to the minority stock, which all agreed was to pass to taxpayers, but rather was concerned solely with the value of that stock. fn6

fn6 Taxpayers argue at length that under Iowa law title to the stock passed before the appraisal proceeding. The court of appeals viewed Iowa law differently, and it seems to us that it was correct in so doing. See United States v. Hilton Hotels Corp., post, at 583-584, n. 2. But resolution of this question of state law makes no difference and is not necessary for decision of the case, since, as we hold in *Hilton Hotels*, the sequence in which title passes and price is determined is irrelevant for purposes of the tax question involved here.

We agree with the tax court and the court of appeals that the "primary purpose" test has no application here. That uncertain and difficult test may be the best that can be devised to determine the tax treatment of costs incurred in litigation that may affect a taxpayer's title to property more or less indirectly, and that thus calls for a judgment whether the taxpayer can fairly be said to be "defending or perfecting title." Such uncertainty is not called for in applying the regulation that makes the "cost of acquisition" of a capital asset a capital expense. In our view application of the latter regulation to litigation expenses involves the simpler inquiry whether the origin of the claim litigated is in the process of acquisition itself.

A test based upon the taxpayer's "purpose" in undertaking or defending a particular piece of

> litigation would encourage resort to formalisms and artificial distinctions. Emphasis added, *id.*

More than give a mere appearance of applying a primary purpose test, the published Tax Court Memorandum at 1108, as shown *supra,* expressly relies on *Boagni v. Commissioner, supra,* 59 USTC 708. This opinion was disapproved by the Ninth Circuit on this very point:

> *Boagni* does not accurately state the origin test. In fact, the criteria listed would be more appropriate for determining the primary purpose of the litigation. This is inconsistent with the Supreme Court's rejection of the purpose test, and it reflects an improper merging of the attribution step with the ultimate characterization decision. *Keller Street Development Co. v. Commissioner* (9th Cir. 1982) 688 F.2d 675, 680.

Suppose, *arguendo,* Taxpayers could report an asset as ordinary income, perhaps by writing the words "ordinary income" on the appropriate line of his Form 1040. His election would still be irrelevant under the Origin of the Claim Test. In this case, the IRS urged that Taxpayers reported their pensions as ordinary income, and that their election was determinative. What actually transpired was that the IRS stipulated that Taxpayers reported their pensions on line 17 of the 1992 Form 1040. Stip. 23. Then it urged,

> All the various categories of income on the first page of the Form 1040, *e.g.*, wages, dividends, interest, are ordinary income, *i.e.*, are subject to tax at the regular income tax rates. Capital gains income, which is taxed at a special lower rate, is reported on Schedule D. IRS OB, 21.

This was to support the theory that how the Taxpayer interprets and uses the Form 1040 affects the taxable nature of income:

> Taxpayers' position on appeal in entirely inconsistent with their own tax return for the year in

> issue (1992). On that return, taxpayers reported the monthly payments as ordinary pension/annuity income and treated the litigation expenses as an itemized deduction. They did not report the monthly payments on Schedule D which is the schedule used to report capital gains income. 9th IRS OB, 12.
>
> It therefore follows, as taxpayers reported on their tax return, that the retirement benefits received by Mrs. Glassman were taxable as ordinary income, not capital gain. 9th IRS OB, 12.
>
> Capital gain must be reported on a Schedule D. [Citation.] Instead, taxpayers reported the monthly payments as pension/annuity income--income that is taxable at the normal, ordinary income tax rates. 9th IRS OB, 16-17.

The IRS urging on income reporting contains the following four discrepancies:

1. Taxpayers have no choice. The IRS instructs them to report gross pensions and taxable pensions on lines 17a and 17b, respectively.

2. The difference between gross and taxable pensions, if any, is the cost basis. When a basis exists, the pension must be a capital asset. As shown *supra*,

> The fact remains, however, that the Code simply does not provide for the offsetting of basis... except in limited cases involving capital assets. Emphasis added, *Alexander*, 943, fn. 9

In this case, Taxpayers reported gross pensions for 1992 of $119,783.64 and taxable pensions of $108,050.04. Ex. 1-A. Therefore Taxpayers reported a basis, and thereby reported their pension income as a capital asset, not ordinary income as the IRS urged and the courts believed.

Unfortunately, the Commissioner did not anticipate a contest with a pension plan, and additional capital expenses such as legal expenses to offset the gross income. The Form 1040 and its various Schedules are missing that provision,

and Taxpayers are left to fashion their own remedy.[8]

3. The Form 1040 has no place for income expressly called "ordinary". The word is not used on the Form. Taxpayers have no way to know which of the many slots might be ordinary, capital asset, or other.

4. "All the various categories of income on the first page of the Form 1040... are [NOT] ordinary income." The IRS goes too far.

Schedule D is indeed for collecting and reporting SOME capital gains, and the net results are reported as income on the first page of the 1992 Form 1040 on line 13. Other capital gains and losses are reported on line 14. Income from the sale or exchange of business property is NOT ordinary income, and it, too, is reported first on a Form 4797 and then on line 15 of the 1992 Form 1040. IRA distributions on line 16, pensions and annuities on line 17, and social security benefits on line 21 all have places to report the gross and the taxable portions, which is to recognize that these categories of income have a basis.

The dispute in this case is whether the particular pension annuity was a capital asset, and the IRS declares that it is not by misrepresenting the Form 1040. The Service then uses the result to urge that the Taxpayers in following the IRS instructions in filling in the Form 1040 waived any right to have their pension treated as a capital asset.

---

[8]Lacking a place on the forms to add to the pension basis, Taxpayers here reported their legal expenses on Schedule A, line 25 instead of line 20, thus avoiding the Alternative Minimum Tax computation as would an offset allowance to the basis. Stip. 20.

Conclusion

To analyze for the tax treatment of legal expenses, this Court constructed the Origin of the Claim Test. The published Tax Court Memorandum pays lip service to it. It fails to make the requisite factual findings, fails to apply the judicial and statutory standards, and instead restores disapproved criteria.

The Tax Court opinion found that a pension annuity voluntarily purchased with after-tax dollars is necessarily ordinary income, and therefore the legal expenses to enforce payment of an order for its distribution are taxable under the Alternative Minimum Tax.

The Opinion ignored the definition of capital assets at § 1221 to assume and conclude that a pension is not a capital asset. The Opinion overlooked that the stipulations of fact only support that this and such purchased pensions are not deferred compensation for services. Yet it concluded that all, even purchased pension payments, were ordinary income, just because pension distributions are § 61(a) gross income.

This opinion publishes the instruction that all pensions always pay wholly ordinary income. This opinion thereby makes superfluous 26 U.S.C. §72(u), which provides that annuities are treated as ordinary income only for other than natural persons. This opinion relies on *Boagni v. Commissioner, supra,* 59 USTC 708, a case previously disapproved because it relies on the primary purpose test expressly disapproved by this Court in *Woodward.*

The courts below found that because Taxpayers reported their pensions on Form 1040 line 17 they waived the right to claim that the pensions were capital assets. The stipulated facts are that the Taxpayers reported their pensions as capital assets by reporting an offsetting basis. The courts below looked forward from the Taxpayers' originating activity to where on the Form 1040 they reported the income from the originating activity. That originating activity was the after-tax dollar purchase of an annuity to gain profit. The

forward looking test is also disapproved in *Woodward*, which furthered and explained the Origin of the Claim Test.

For all the reasons stated above, the Tax Court opinion must be reversed.

DATED:
February 28, 2000

Respectfully submitted,

ROBERT GLASSER
(*Counsel of Record*)
GLASSER AND SMITH, APC
901 Dove St., Suite 299
Newport Beach,
California 92660-3018
(949) 752-2727
Attorneys for Petitioner

APPENDIX

APPENDIX A: GLASSMAN V CIR (9TH CIR. 1999), NO. 98-70151, TAX CT. NO. 27001-95, MEMORANDUM

FILED October 19, 1999,
Cathy A. Catterson, Clerk,
U.S. Court of Appeals

NOT FOR PUBLICATION
UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

JEFFREY A. GLASSMAN and MARK[2] K. GLASSMAN,
Petitioners-Appellants,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee

No. 98-70151
Tax Ct. No. 27001-95

MEMORANDUM[1]

On Petition for Review of an Order of the United States Tax Court

Argued and Submitted October 15, 1999
Pasadena, California

Before: THOMAS, SILVERMAN and WARDLAW, Circuit Judges.

Jeffrey A. and Mary K. Glassman appeal from a judgment in the United States Tax Court upholding the commissioner of Internal Revenue's determination of a deficiency on the Glassman's 1992 tax return. We affirm for the reasons stated in the tax court opinion.

1 This disposition is not appropriate for publication and may not be cited to or by the courts of this circuit as may be provided by Ninth Circuit Rule 36-3.

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[2]So in original.

APPENDIX B: GLASSMAN V CIR (1991), TCM 1997-497, 74 TCM 1106

T.C. Memo. 1997-497

UNITED STATES TAX COURT

JEFFREY A. GLASSMAN and MARY K. GLASSMAN Petîtioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 27001-95. Filed November 5, 1997.

Terrence J. Moore, for petitioner.

Mary Tseng Klaasen, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

FOLEY, *Judge:* Respondent determined a deficiency of $17,047.96 in petitioners' 1992 Federal income tax. Unless otherwise indicated, all section references are to the Internal Revenue Code in affect for the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure. After concessions, the issues for decision are whether petitioners' expenditures for legal services, which respondent agrees are deductible pursuant to section 212, are subject to section 67(a) and that their expenditures are not capital expenditures.

FINDINGS OF FACT

The parties submitted this case fully stipulated pursuant to Rule 122. At the time Jeffrey and Mary Glassman filed their petition, they resided in Lake Forest, California.

In 1954, Mary Glassman married James M. Oddino. During their marriage, Mr. Oddino was employed by the Hughes Aircraft Company and participated in the Hughes Non-Bargaining Retirement Plan (Hughes Plan). On January 19, {1107} 1983, the Superior Court of the State of California, County of Los Angeles (Superior Court), issued an interlocutory judgment that dissolved the marriage and awarded Mrs. Glassman a portion of Mr. Oddino's retirement benefits. On March 74, 1989, the Superior Court issued a Qualified Domestic Relations Order that modified and

clarified the interlocutory judgment. The QDRO directed the Hughes Plan to: (1) Pay Mrs. Glassman 36.6231 percent of Mr. Oddino's "accrued benefit[s] as of April 1, 1988"; (2) convert Mrs. Glassman's payout option from a lifetime annuity to an annuity with a 5-year payout period (i.e., payable in 60 monthly installments) and (3) commence payments on "April 1, 1988, or as soon thereafter as practical."

The Hughes Plan administrator (administrator) calculated Mr. Oddino's "accrued benefit(s) as of April 1, 1988." Under the plan, "accrued benefits" are a function of the employee's age and, in certain instances, years of service. In general, employees who retire at age 65 or older receive full retirement benefits. Employees who retire between the ages of 55 and 64 receive actuarially reduced benefits. Under the Rule of 75," however, employees between the ages of 55 and 64 can retire and receive full, unreduced benefits if the sum of their age and years of service equals or exceeds 75. On April 1, 1988, the date used to calculate benefits pursuant to the QDRO, Mr. Oddino had not yet retired, was 55 years old, and had worked for Hughes for approximately 27 years. In calculating Mrs. Glassman's community share, the administrator did not apply the Rule of 75. Instead, the administrator calculated the accrued benefits in accordance with the general rule for retirees between the ages of 55 and 64. The administrator determined that Mrs. Glassman was entitled to receive sixty $1,563.70 monthly installments, and on March 1, 1990, the administrator commenced payments.

Mrs. Glassman objected to the administrator's determination, and on July 11, 1991, flied a Motion to Show Cause, in which she alleged that the administrator (1) improperly calculated the amount of accrued benefits and (2) unreasonably delayed payments. She contends that the administrator should have applied the Rule of 75 because, on the date specified in the QDRO, Mr. Oddino met the age and service requirements. She asked the court to recalculate her

benefits and award interest, attorney's fees, and costs. The Hughes Plan responded that: (1) California law and the Employee Retirement Income Security Act prohibit the plan from using the Rule of 75 to calculate Mrs. Glassman's share of Mr. Oddino's benefits; and (2) the Rule of 75 is an incentive for early retirement that is applicable only if the employee actually retires.

On Mary 3, 1992, the Superior Court denied Mrs. Glassman's motion and held that the administrator had not erred in its calculation. The California Court of Appeal, Second Appellate District, reversed the lower court's holding and, on July 4, 1996, entered judgment for Mrs. Glassman. The Hughes Plan filed a timely appeal with the California Supreme Court, where the action was pending on the date we held trial.

Petitioners, on their 1992 joint tax return, claimed an $80,468.31 itemized deduction for attorney's fees paid in connection with their litigation against the Hughes Plan. In the notice of deficiency, respondent determined that the deduction was subject to section 67(a) and that petitioners were subject to the alternative minimum tax.

OPINION

The parties agree that if petitioners' payments relating to attorney's fees are not capital expenditures, such payments are deductible pursuant to section 212. Petitioners' primary contention is that their section 212 deduction for attorney's fees is not subject to section 67(a), which allows miscellaneous itemized deductions only to the extent that such deductions exceed 2 percent of adjusted gross income (the 2-percent floor). Respondent, however, contends that the deduction is subject to the 2-percent floor. We agree with respondent. Section 67(a) expressly permits miscellaneous itemized deduction only to the extent such deductions exceed 2 percent of adjusted gross income. The section 212 deduction is a miscellaneous itemized deduction that is subject to this limitation. *Alexander v. Commissioner*, 72

F.3d 938, 946 (1st Cir. 1995), affg. T.C. Memo. 1995-51; secs. 63(d), 67(a) and (b); sec. 1.67-1T(a)(1)(ii), Temporary Income Tax Regs., 53 Fed.Reg. 9875 (Mar. 28, 1988). Therefore, petitioners' primary contention is meritless.

In the alternative, petitioners contend that their payments are capital expenditures that increase the basis of Mrs. Glassman's interest in Mr. Oddino's pension benefits. Pursuant to this theory, petitioners contend that Mrs. Glassman's interest is a capital asset that Mrs. Glassman sold to the Hughes Plan in exchange for 60 monthly payments and that her basis offset funds she received from the plan. For the reasons set forth below we conclude that the payments are not capital expenditures.

Generally, expenses must be capitalized if they are paid to acquire, dispose, defend, perfect title to, or improve property. Sec. 263(a); sec. 1.212-1(k), Income Tax Regs. Petitioners contend that, under the origin of the claim test, their payments are capital expenditures. Because this case is appealable to the Court of Appeals for the Ninth Circuit, we must apply the Ninth Circuit's version of the origin of the {1108} claim test. *Golsen v. Commissioner*, 54 T.C. 742 (1970), affd. 445 F.2d 955 (10th Cir. 1971). In *Keller St. Dev. Co. v. Commissioner*, 688 F.2d 675, 678 (9th Cir. 1982), affg. T.C. Memo. 1978-350, the Court of Appeals for the Ninth Circuit stated that the origin of the claim test is a 2-step process. Cf. *Boagni v. Commissioner*, 59 T.C. 708 (1973) (applying a list of factors).

The first step requires us to identify the transaction or event from which the claim originated (i.e., the event that prompted the cause of action and formed the basis of the suit). *Keller St. Dev. Co. v. Commissioner*, *supra* at 681. Mrs. Glassman's claim against the Hughes Plan originated from the administrator's calculation and payment of her community share of retirement benefits. The administrator's actions prompted Mrs. Glassman to file her claim and formed the basis of her cause of action.

The second step requires us to characterize the transaction that we identified in the first step. *Id.* at 678. Respondent contends that the taxable portion of the income stream from the Hughes Plan is ordinary income. See secs. 61(a)(11), 72, 402(a); *Eatinger v. Commissioner*, T.C. Memo. 1990-310. Indeed, petitioners consistently reported the taxable portion of all payments from the plan as ordinary income. We conclude that Mrs. Glassman's claim relates to the calculation of benefits under the Hughes Plan, not to a "capital transaction" (e.g., the acquisition, disposition, defense, or protection of title to property). Therefore, petitioners' expenditures are not capital expenditures. See *Dye v. United States*, 121 F.3d 1399, 1405 (10th Cir. 1997) (stating that expenditures for attorney's fees are not capital expenditures if incurred to secure taxable, ordinary income); see also *Leonard v. Commissioner*, 94 F.3d 523, 525 (9th Cir. 1996); *Parker v. United States*, 215 Ct. Cl. 773, 573 F.2d 42, 51 (1978); cf. *Pierce Estates, Inc. v. Commissioner*, 3 T.C. 875, 892-893 (1944) (holding that expenditures for attorney's fees are not capital expenditures where incurred in litigation over the proper method of calculating how much income petitioners were entitled to pursuant to their interest in an oil lease).

All other arguments raised by the parties are either irrelevant, moot, or without merit.

To reflect the foregoing,

Decision will be entered under Rule 155.

APPENDIX C: GLASSMAN V CIR (9TH CIR. 1999), NO. 98-70151, TAX CT. NO. 27001-95, ORDER

FILED December 2 1999,
Cathy A. Catterson, Clerk,
U.S. Court of Appeals

NOT FOR PUBLICATION
UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

JEFFREY A. GLASSMAN and MARK[1] K. GLASSMAN,
Petitioners-Appellants,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee

No. 98-70151
Tax Ct. No. 27001-95

ORDER

On Petition for Review of an Order
of the United States Tax Court
Argued and Submitted October 15, 1999
Pasadena, California

Before: THOMAS, SILVERMAN and WARDLAW, Circuit Judges.

The panel has voted to deny the petition for rehearing and to reject the suggestion for rehearing en banc.

The full court has been advised of the suggestion for rehearing en banc, and no judge of the court has requested a vote on the suggestion for rehearing en banc. Fed.R.App.P. 35(b).

The petition for rehearing is denied and the suggestion for rehearing en banc is rejected.

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[1]So in original.

APPENDIX D: UNTIED STATES CODE

26 U.S.C. § 61. Gross income defined

(a) General definition

Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, fringe benefits, and similar items;
(2) Gross income derived from business;
(3) Gains derived from dealings in property;
(4) Interest;
(5) Rents;
(6) Royalties;
(7) Dividends;
(8) Alimony and separate maintenance payments;
(9) Annuities;
(10) Income from life insurance and endowment contracts;
(11) Pensions;
(12) Income from discharge of indebtedness;
(13) Distributive share of partnership gross income;
(14) Income in respect of a decedent; and
(15) Income from an interest in an estate or trust.

---

26 U.S.C. § 64. Ordinary income defined

For purposes of this subtitle, the term "ordinary income" includes any gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b).

Any gain from the sale or exchange of property which is treated or considered, under other provisions of this subtitle, as "ordinary income" shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b).

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26 U.S.C. § 72. Annuities; certain proceeds of endowment and life insurance contracts

(a) General rule for annuities

Except as otherwise provided in this chapter, gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity, endowment, or life insurance contract.

(b) Exclusion ratio

(1) In general

Gross income does not include that part of any amount received as an annuity under an annuity, endowment, or life insurance contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date).

(2) Exclusion limited to investment

The portion of any amount received as an annuity which is excluded from gross income under paragraph (1) shall not exceed the unrecovered investment in the contract immediately before the receipt of such amount.

(3) Deduction where annuity payments cease before entire investment recovered

(A) In general

If -

(i) after the annuity starting date, payments as an annuity under the contract cease by reason of the death of an annuitant, and

(ii) as of the date of such cessation, there is unrecovered investment in the contract, the amount of such unrecovered investment (in excess of any amount specified in subsection (e)(5) which was not included in gross income) shall be allowed as a deduction to the annuitant for his last taxable year.

(B) Payments to other persons

In the case of any contract which provides for payments meeting the requirements of subparagraphs (B) and (C) of

subsection (c)(2), the deduction under subparagraph (A) shall be allowed to the person entitled to such payments for the taxable year in which such payments are received.

(C) Net operating loss deductions provided

For purposes of section 172, a deduction allowed under this paragraph shall be treated as if it were attributable to a trade or business of the taxpayer.

(4) Unrecovered investment

For purposes of this subsection, the unrecovered investment in the contract as of any date is -

(A) the investment in the contract (determined without regard to subsection (c)(2)) as of the annuity starting date, reduced by

(B) the aggregate amount received under the contract on or after such annuity starting date and before the date as of which the determination is being made, to the extent such amount was excludable from gross income under this subtitle.

(c) Definitions

(1) Investment in the contract

For purposes of subsection (b), the investment in the contract as of the annuity starting date is -

(A) the aggregate amount of premiums or other consideration paid for the contract, minus

(B) the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.

(2) Adjustment in investment where there is refund feature

If -

(A) the expected return under the contract depends in whole or in part on the life expectancy of one or more individuals,

(B) the contract provides for payments to be made to a beneficiary (or to the estate of an annuitant) on or after the

death of the annuitant or annuitants; and

(C) such payments are in the nature of a refund of the consideration paid, then the value (computed without discount for interest) of such payments on the annuity starting date shall be subtracted from the amount determined under paragraph (1). Such value shall be computed in accordance with actuarial tables prescribed by the Secretary. For purposes of this paragraph and of subsection (e)(2)(A), the term "refund of the consideration paid" includes amounts payable after the death of an annuitant by reason of a provision in the contract for a life annuity with minimum period of payments certain, but (if part of the consideration was contributed by an employer) does not include that part of any payment to a beneficiary (or to the estate of the annuitant) which is not attributable to the consideration paid by the employee for the contract as determined under paragraph (1)(A).

(3) Expected return

For purposes of subsection (b), the expected return under the contract shall be determined as follows:

(A) Life expectancy

If the expected return under the contract, for the period on and after the annuity starting date, depends in whole or in part on the life expectancy of one or more individuals, the expected return shall be computed with reference to actuarial tables prescribed by the Secretary.

(B) Installment payments

If subparagraph (A) does not apply, the expected return is the aggregate of the amounts receivable under the contract as an annuity.

(4) Annuity starting date

For purposes of this section, the annuity starting date in the case of any contract is the first day of the first period for which an amount is received as an annuity under the contract, except that if such date was before January 1, 1954, then the annuity starting date is January 1, 1954.

(d) Special rules for qualified employer retirement plans

(1) Simplified method of taxing annuity payments

(A) In general

In the case of any amount received as an annuity under a qualified employer retirement plan -

(i) subsection (b) shall not apply, and

(ii) the investment in the contract shall be recovered as provided in this paragraph

(B) Method of recovering investment in contract

(i) In general

Gross income shall not include so much of any monthly annuity payment under a qualified employer retirement plan as does not exceed the amount obtained by dividing -

(I) the investment in the contract (as of the annuity starting date), by

(II) the number of anticipated payments determined under the table contained in clause (iii) (or, in the case of a contract to which subsection (c)(3)(B) applies, the number of monthly annuity payments under such contract)

(ii) Certain rules made applicable

Rules similar to the rules of paragraphs (2) and (3) of subsection (b) shall apply for purposes of this paragraph

(iii) Number of anticipated payments

If the age of the primary annuitant on the annuity starting date is	The number of anticipated payments is
Not more than 55	360
More than 55 but not more than 60	310
More than 60 but not more than 65	260
More than 65 but not more than 70	210
More than 70	160

(C) Adjustment for refund feature not applicable

For purposes of this paragraph, investment in the contract shall be determined under subsection (c)(1) without regard to subsection (c)(2)

(D) Special rule where lump sum paid in connection with commencement of annuity payments

If, in connection with the commencement of annuity payments under any qualified employer retirement plan, the taxpayer receives a lump-sum payment -

(i) such payment shall be taxable under subsection (e) as if received before the annuity starting date, and

(ii) the investment in the contract for purposes of this paragraph shall be determined as if such payment had been so received

(E) Exception

This paragraph shall not apply in any case where the primary annuitant has attained age 75 on the annuity starting date unless there are fewer than 5 years of guaranteed payments under the annuity

(F) Adjustment where annuity payments not on monthly basis

In any case where the annuity payments are not made on a monthly basis, appropriate adjustments in the application of this paragraph shall be made to take into account the period on the basis of which such payments are made

(G) Qualified employer retirement plan

For purposes of this paragraph, the term "qualified employer retirement plan" means any plan or contract described in paragraph (1), (2), or (3) of section 4974(c)

(2) Treatment of employee contributions under defined contribution plans

For purposes of this section, employee contributions (and any income allocable thereto) under a defined contribution plan may be treated as a separate contract

(e) Amounts not received as annuities

(1) Application of subsection (A) In general

This subsection shall apply to any amount which -

(i) is received under an annuity, endowment, or life insurance contract, and

(ii) is not received as an annuity, if no provision of this subtitle (other than this subsection) applies with respect to such amount

(B) Dividends

For purposes of this section, any amount received which is in the nature of a dividend or similar distribution shall be treated as an amount not received as an annuity.

(2) General rule

Any amount to which this subsection applies -

(A) if received on or after the annuity starting date, shall be included in gross income, or

(B) if received before the annuity starting date -

(i) shall be included in gross income to the extent allocable to income on the contract, and

(ii) shall not be included in gross income to the extent allocable to the investment in the contract.

(3) Allocation of amounts to income and investment

For purposes of paragraph (2)(B) -

(A) Allocation to income

Any amount to which this subsection applies shall be treated as allocable to income on the contract to the extent that such amount does not exceed the excess (if any) of -

(i) the cash value of the contract (determined without regard to any surrender charge) immediately before the amount is received, over

(ii) the investment in the contract at such time.

(B) Allocation to investment

Any amount to which this subsection applies shall be treated as allocable to investment in the contract to the extent that such amount is not allocated to income under subparagraph (A).

(4) Special rules for application of paragraph (2)(B)

For purposes of paragraph (2)(B) -

(A) Loans treated as distributions

If, during any taxable year, an individual -

(i) receives (directly or indirectly) any amount as a loan under any contract to which this subsection applies, or

(ii) assigns or pledges (or agrees to assign or pledge) any portion of the value of any such contract, such amount or

portion shall be treated as received under the contract as an amount not received as an annuity. The preceding sentence shall not apply for purposes of determining investment in the contract, except that the investment in the contract shall be increased by any amount included in gross income by reason of the amount treated as received under the preceding sentence.

(B) Treatment of policyholder dividends

Any amount described in paragraph (1)(B) shall not be included in gross income under paragraph (2)(B)(i) to the extent such amount is retained by the insurer as a premium or other consideration paid for the contract.

(C) Treatment of transfers without adequate consideration

(i) In general

If an individual who holds an annuity contract transfers it without full and adequate consideration, such individual shall be treated as receiving an amount equal to the excess of -

(I) the cash surrender value of such contract at the time of transfer, over

(II) the investment in such contract at such time, under the contract as an amount not received as an annuity.

(ii) Exception for certain transfers between spouses or former spouses

Clause (i) shall not apply to any transfer to which section 1041(a) (relating to transfers of property between spouses or incident to divorce) applies.

(iii) Adjustment to investment in contract of transferee

If under clause (i) an amount is included in the gross income of the transferor of an annuity contract, the investment in the contract of the transferee in such contract shall be increased by the amount so included.

(5) Retention of existing rules in certain cases

(A) In general

In any case to which this paragraph applies -

(i) paragraphs (2)(B) and (4)(A) shall not apply, and

(ii) if paragraph (2)(A) does not apply, the amount shall be included in gross income, but only to the extent it exceeds the investment in the contract.

(B) Existing contracts

This paragraph shall apply to contracts entered into before August 14, 1982. Any amount allocable to investment in the contract after August 13, 1982, shall be treated as from a contract entered into after such date.

(C) Certain life insurance and endowment contracts

Except as provided in paragraph (10) and except to the extent prescribed by the Secretary by regulations, this paragraph shall apply to any amount not received as an annuity which is received under a life insurance or endowment contract.

(D) Contracts under qualified plans

Except as provided in paragraph (8), this paragraph shall apply to any amount received -

(i) from a trust described in section 401(a) which is exempt from tax under section 501(a),

(ii) from a contract -

(I) purchased by a trust described in clause (i),

(II) purchased as part of a plan described in section 403(a),

(III) described in section 403(b), or

(IV) provided for employees of a life insurance company under a plan described in section 818(a)(3), or

(iii) from an individual retirement account or an individual retirement annuity.

Any dividend described in section 404(k) which is received by a participant or beneficiary shall, for purposes of this subparagraph, be treated as paid under a separate contract to which clause (ii)(I) applies.

(E) Full refunds, surrenders, redemptions, and maturities

This paragraph shall apply to -

(i) any amount received, whether in a single sum or otherwise, under a contract in full discharge of the obligation

under the contract which is in the nature of a refund of the consideration paid for the contract, and

(ii) any amount received under a contract on its complete surrender, redemption, or maturity.

In the case of any amount to which the preceding sentence applies, the rule of paragraph (2)(A) shall not apply.

(6) Investment in the contract

For purposes of this subsection, the investment in the contract as of any date is -

(A) the aggregate amount of premiums or other consideration paid for the contract before such date, minus

(B) the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.

((7) Repealed. Pub. L. 100-647, title I, Sec. 1011A(b)(9)(A), Nov. 10, 1988, 102 Stat. 3474)

(8) Extension of paragraph (2)(b) (FOOTNOTE 1) to qualified plans

(FOOTNOTE 1) So in original. Probably should be paragraph "(2)(B)".

(A) In general

Notwithstanding any other provision of this subsection, in the case of any amount received before the annuity starting date from a trust or contract described in paragraph (5)(D), paragraph (2)(B) shall apply to such amounts.

(B) Allocation of amount received

For purposes of paragraph (2)(B), the amount allocated to the investment in the contract shall be the portion of the amount described in subparagraph (A) which bears the same ratio to such amount as the investment in the contract bears to the account balance. The determination under the preceding sentence shall be made as of the time of the distribution or at such other time as the Secretary may prescribe.

(C) Treatment of forfeitable rights

If an employee does not have a nonforfeitable right to any amount under any trust or contract to which subparagraph (A) applies, such amount shall not be treated as part of the account balance.

(D) Investment in the contract before 1987

In the case of a plan which on May 5, 1986, permitted withdrawal of any employee contributions before separation from service, subparagraph (A) shall apply only to the extent that amounts received before the annuity starting date (when increased by amounts previously received under the contract after December 31, 1986) exceed the investment in the contract as of December 31, 1986.

((9) Repealed. Pub. L. 100-647, title I, Sec. 1011A(b)(2)(B), Nov. 10, 1988, 102 Stat. 3473)

(10) Treatment of modified endowment contracts

(A) In general

Notwithstanding paragraph (5)(C), in the case of any modified endowment contract (as defined in section 7702A) -

(i) paragraphs (2)(B) and (4)(A) shall apply, and

(ii) in applying paragraph (4)(A), "any person" shall be substituted for "an individual".

(B) Treatment of certain burial contracts

Notwithstanding subparagraph (A), paragraph (4)(A) shall not apply to any assignment (or pledge) of a modified endowment contract if such assignment (or pledge) is solely to cover the payment of expenses referred to in section 7702(e)(2)(C)(iii) and if the maximum death benefit under such contract does not exceed $25,000.

(11) Anti-abuse rules

(A) In general

For purposes of determining the amount includible in gross income under this subsection -

(i) all modified endowment contracts issued by the same company to the same policyholder during any calendar year shall be treated as 1 modified endowment contract, and

(ii) all annuity contracts issued by the same company to

the same policyholder during any calendar year shall be treated as 1 annuity contract.

The preceding sentence shall not apply to any contract described in paragraph (5)(D).

(B) Regulatory authority

The Secretary may by regulations prescribe such additional rules as may be necessary or appropriate to prevent avoidance of the purposes of this subsection through serial purchases of contracts or otherwise.

(f) Special rules for computing employees' contributions

In computing, for purposes of subsection (c)(1)(A), the aggregate amount of premiums or other consideration paid for the contract, and for purposes of subsection (e)(6), the aggregate premiums or other consideration paid, amounts contributed by the employer shall be included, but only to the extent that -

(1) such amounts were includible in the gross income of the employee under this subtitle or prior income tax laws; or

(2) if such amounts had been paid directly to the employee at the time they were contributed, they would not have been includible in the gross income of the employee under the law applicable at the time of such contribution.

Paragraph (2) shall not apply to amounts which were contributed by the employer after December 31, 1962, and which would not have been includible in the gross income of the employee by reason of the application of section 911 if such amounts had been paid directly to the employee at the time of contribution. The preceding sentence shall not apply to amounts which were contributed by the employer, as determined under regulations prescribed by the Secretary, to provide pension or annuity credits, to the extent such credits are attributable to services performed before January 1, 1963, and are provided pursuant to pension or annuity plan provisions in existence on March 12, 1962, and on that date applicable to such services, or to the extent such credits are attributable to services performed as a foreign missionary

(within the meaning of section 403(b)(2)(D)(iii)).

(g) Rules for transferee where transfer was for value

Where any contract (or any interest therein) is transferred (by assignment or otherwise) for a valuable consideration, to the extent that the contract (or interest therein) does not, in the hands of the transferee, have a basis which is determined by reference to the basis in the hands of the transferor, then -

(1) for purposes of this section, only the actual value of such consideration, plus the amount of the premiums and other consideration paid by the transferee after the transfer, shall be taken into account in computing the aggregate amount of the premiums or other consideration paid for the contract;

(2) for purposes of subsection (c)(1)(B), there shall be taken into account only the aggregate amount received under the contract by the transferee before the annuity starting date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws; and

(3) the annuity starting date is January 1, 1954, or the first day of the first period for which the transferee received an amount under the contract as an annuity, whichever is the later.

For purposes of this subsection, the term "transferee" includes a beneficiary of, or the estate of, the transferee.

(h) Option to receive annuity in lieu of lump sum

If -

(1) a contract provides for payment of a lump sum in full discharge of an obligation under the contract, subject to an option to receive an annuity in lieu of such lump sum;

(2) the option is exercised within 60 days after the day on which such lump sum first became payable; and

(3) part or all of such lump sum would (but for this subsection) be includible in gross income by reason of subsection (e)(1), then, for purposes of this subtitle, no part of such lump sum shall be considered as includible in gross income at the time such lump sum first became payable.

((i) Repealed. Pub. L. 94-455, title XIX, Sec. 1951(b)(1)(A), Oct. 4, 1976, 90 Stat. 1836)

(j) Interest

Notwithstanding any other provision of this section, if any amount is held under an agreement to pay interest thereon, the interest payments shall be included in gross income.

((k) Repealed. Pub. L. 98-369, div. A, title IV, Sec. 421(b)(1), July 18, 1984, 98 Stat. 794)

(l) Face-amount certificates

For purposes of this section, the term "endowment contract" includes a face-amount certificate, as defined in section 2(a)(15) of the Investment Company Act of 1940 (15 U.S.C., sec. 80a-2), issued after December 31, 1954.

(m) Special rules applicable to employee annuities and distributions under employee plans

((1) Repealed. Pub. L. 93-406, title II, Sec. 2001(h)(2), Sept. 2, 1974, 88 Stat. 957)

(2) Computation of consideration paid by the employee

In computing -

(A) the aggregate amount of premiums or other consideration paid for the contract for purposes of subsection (c)(1)(A) (relating to the investment in the contract), and

(B) the aggregate premiums or other consideration paid for purposes of subsection (e)(6) (relating to certain amounts not received as an annuity), any amount allowed as a deduction with respect to the contract under section 404 which was paid while the employee was an employee within the meaning of section 401(c)(1) shall be treated as consideration contributed by the employer, and there shall not be taken into account any portion of the premiums or other consideration for the contract paid while the employee was an owner-employee which is properly allocable (as determined under regulations prescribed by the Secretary) to the cost of life, accident, health, or other insurance.

(3) Life insurance contracts

(A) This paragraph shall apply to any life insurance contract -

(i) purchased as a part of a plan described in section 403(a), or

(ii) purchased by a trust described in section 401(a) which is exempt from tax under section 501(a) if the proceeds of such contract are payable directly or indirectly to a participant in such trust or to a beneficiary of such participant.

(B) Any contribution to a plan described in subparagraph (A)(i) or a trust described in subparagraph (A)(ii) which is allowed as a deduction under section 404, and any income of a trust described in subparagraph (A)(ii), which is determined in accordance with regulations prescribed by the Secretary to have been applied to purchase the life insurance protection under a contract described in subparagraph (A), is includible in the gross income of the participant for the taxable year when so applied.

(C) In the case of the death of an individual insured under a contract described in subparagraph (A), an amount equal to the cash surrender value of the contract immediately before the death of the insured shall be treated as a payment under such plan or a distribution by such trust, and the excess of the amount payable by reason of the death of the insured over such cash surrender value shall not be includible in gross income under this section and shall be treated as provided in section 101.

((4) Repealed. Pub. L. 97-248, title II, Sec. 236(b)(1), Sept. 3, 1982, 96 Stat. 510)

(5) Penalties applicable to certain amounts received by 5-percent owners

(A) This paragraph applies to amounts which are received from a qualified trust described in section 401(a) or under a plan described in section 403(a) at any time by an individual who is, or has been, a 5-percent owner, or by a successor of such an individual, but only to the extent such

amounts are determined, under regulations prescribed by the Secretary, to exceed the benefits provided for such individual under the plan formula.

(B) If a person receives an amount to which this paragraph applies, his tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of the amount so received which is includible in his gross income for such taxable year.

(C) For purposes of this paragraph, the term "5-percent owner" means any individual who, at any time during the 5 plan years preceding the plan year ending in the taxable year in which the amount is received, is a 5-percent owner (as defined in section 416(i)(1)(B)).

(6) Owner-employee defined

For purposes of this subsection, the term "owner-employee" has the meaning assigned to it by section 401(c)(3) and includes an individual for whose benefit an individual retirement account or annuity described in section 408(a) or (b) is maintained. For purposes of the preceding sentence, the term "owner-employee" shall include an employee within the meaning of section 401(c)(1).

(7) Meaning of disabled

For purposes of this section, an individual shall be considered to be disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. An individual shall not be considered to be disabled unless he furnishes proof of the existence thereof in such form and manner as the Secretary may require.

((8) Repealed. Pub. L. 97-248, title II, Sec. 236(b)(1), Sept. 3, 1982, 96 Stat. 510)

((9) Repealed. Pub. L. 98-369, div. A, title VII, Sec. 713(d)(1), July 18, 1984, 98 Stat. 957)

(10) Determination of investment in the contract in the

case of qualified domestic relations orders

Under regulations prescribed by the Secretary, in the case of a distribution or payment made to an alternate payee who is the spouse or former spouse of the participant pursuant to a qualified domestic relations order (as defined in section 414(p)), the investment in the contract as of the date prescribed in such regulations shall be allocated on a pro rata basis between the present value of such distribution or payment and the present value of all other benefits payable with respect to the participant to which such order relates.

(n) Annuities under retired serviceman's family protection plan or survivor benefit plan

Subsection (b) shall not apply in the case of amounts received after December 31, 1965, as an annuity under chapter 73 of title 10 of the United States Code, but all such amounts shall be excluded from gross income until there has been so excluded (under section 122(b)(1) or this section, including amounts excluded before January 1, 1966) an amount equal to the consideration for the contract (as defined by section 122(b)(2)), plus any amount treated pursuant to section 101(b)(2)(D) (FOOTNOTE 2) as additional consideration paid by the employee. Thereafter all amounts so received shall be included in gross income.

(FOOTNOTE 2) See References in Text note below.

(o) Special rules for distributions from qualified plans to which employee made deductible contributions

(1) Treatment of contributions

For purposes of this section and sections 402 and 403, notwithstanding section 414(h), any deductible employee contribution made to a qualified employer plan or government plan shall be treated as an amount contributed by the employer which is not includible in the gross income of the employee.

((2) Repealed. Pub. L. 100-647, title I, Sec. 1011A(c)(8), Nov.

10, 1988, 102 Stat. 3476)

(3) Amounts constructively received

(A) In general

For purposes of this subsection, rules similar to the rules provided by subsection (p) (other than the exception contained in paragraph (2) thereof) shall apply.

(B) Purchase of life insurance

To the extent any amount of accumulated deductible employee contributions of an employee are applied to the purchase of life insurance contracts, such amount shall be treated as distributed to the employee in the year so applied.

(4) Special rule for treatment of rollover amounts

For purposes of sections 402(c), 403(a)(4), and 408(d)(3), the Secretary shall prescribe regulations providing for such allocations of amounts attributable to accumulated deductible employee contributions, and for such other rules, as may be necessary to insure that such accumulated deductible employee contributions do not become eligible for additional tax benefits (or freed from limitations) through the use of rollovers.

(5) Definitions and special rules

For purposes of this subsection -

(A) Deductible employee contributions

The term "deductible employee contributions" means any qualified voluntary employee contribution (as defined in section 219(e)(2)) made after December 31, 1981, in a taxable year beginning after such date and made for a taxable year beginning before January 1, 1987, and allowable as a deduction under section 219(a) for such taxable year.

(B) Accumulated deductible employee contributions

The term "accumulated deductible employee contributions" means the deductible employee contributions -

(i) increased by the amount of income and gain allocable to such contributions, and

(ii) reduced by the sum of the amount of loss and expense allocable to such contributions and the amounts distributed with respect to the employee which are attributable to such

contributions (or income or gain allocable to such contributions).

(C) Qualified employer plan

The term "qualified employer plan" has the meaning given to such term by subsection (p)(3)(A)(i).

(D) Government plan

The term "government plan" has the meaning given such term by subsection (p)(3)(B).

(6) Ordering rules

Unless the plan specifies otherwise, any distribution from such plan shall not be treated as being made from the accumulated deductible employee contributions, until all other amounts to the credit of the employee have been distributed.

(p) Loans treated as distributions

For purposes of this section -

(1) Treatment as distributions

(A) Loans

If during any taxable year a participant or beneficiary receives (directly or indirectly) any amount as a loan from a qualified employer plan, such amount shall be treated as having been received by such individual as a distribution under such plan.

(B) Assignments or pledges

If during any taxable year a participant or beneficiary assigns (or agrees to assign) or pledges (or agrees to pledge) any portion of his interest in a qualified employer plan, such portion shall be treated as having been received by such individual as a loan from such plan.

(2) Exception for certain loans

(A) General rule

Paragraph (1) shall not apply to any loan to the extent that such loan (when added to the outstanding balance of all other loans from such plan whether made on, before, or after August 13, 1982), does not exceed the lesser of -

(i) $50,000, reduced by the excess (if any) of -

(I) the highest outstanding balance of loans from the plan during the 1-year period ending on the day before the date on which such loan was made, over

(II) the outstanding balance of loans from the plan on the date on which such loan was made, or

(ii) the greater of (I) one-half of the present value of the nonforfeitable accrued benefit of the employee under the plan, or (II) $10,000.

For purposes of clause (ii), the present value of the nonforfeitable accrued benefit shall be determined without regard to any accumulated deductible employee contributions (as defined in subsection (o)(5)(B))

(B) Requirement that loan be repayable within 5 years

(i) In general

Subparagraph (A) shall not apply to any loan unless such loan, by its terms, is required to be repaid within 5 years.

(ii) Exception for home loans

Clause (i) shall not apply to any loan used to acquire any dwelling unit which within a reasonable time is to be used

(determined at the time the loan is made) as the principal residence of the participant.

(C) Requirement of level amortization

Except as provided in regulations, this paragraph shall not apply to any loan unless substantially level amortization of such loan (with payments not less frequently than quarterly) is required over the term of the loan.

(D) Related employers and related plans

For purposes of this paragraph -

(i) the rules of subsections (b), (c), and (m) of section 414 shall apply, and

(ii) all plans of an employer (determined after the application of such subsections) shall be treated as 1 plan.

(3) Denial of interest deductions in certain cases

(A) In general

No deduction otherwise allowable under this chapter shall be allowed under this chapter for any interest paid or

accrued on any loan to which paragraph (1) does not apply by reason of paragraph (2) during the period described in subparagraph (B).

(B) Period to which subparagraph (A) applies

For purposes of subparagraph (A), the period described in this subparagraph is the period -

(i) on or after the 1st day on which the individual to whom the loan is made is a key employee (as defined in section 416(i)), or

(ii) such loan is secured by amounts attributable to elective deferrals described in subparagraph (A) or (C) of section 402(g)(3).

(4) Qualified employer plan, etc.

For purposes of this subsection -

(A) Qualified employer plan

(i) In general

The term "qualified employer plan" means -

(I) a plan described in section 401(a) which includes a trust exempt from tax under section 501(a),

(II) an annuity plan described in section 403(a), and

(III) a plan under which amounts are contributed by an individual's employer for an annuity contract described in section 403(b).

(ii) Special rule

The term "qualified employer plan" shall include any plan which was (or was determined to be) a qualified employer plan or a government plan.

(B) Government plan

The term "government plan" means any plan, whether or not qualified, established and maintained for its employees by the United States, by a State or political subdivision thereof, or by an agency or instrumentality of any of the foregoing.

(5) Special rules for loans, etc., from certain contracts

For purposes of this subsection, any amount received as a loan under a contract purchased under a qualified employer

plan (and any assignment or pledge with respect to such a contract) shall be treated as a loan under such employer plan.

(q) 10-percent penalty for premature distributions from annuity contracts

(1) Imposition of penalty

If any taxpayer receives any amount under an annuity contract, the taxpayer's tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income.

(2) Subsection not to apply to certain distributions

Paragraph 1 shall not apply to any distribution -

(A) made on or after the date on which the taxpayer attains age 59 1/2,

(B) made on or after the death of the holder (or, where the holder is not an individual, the death of the primary annuitant (as defined in subsection (s)(6)(B))),

(C) attributable to the taxpayer's becoming disabled within the meaning of subsection (m)(7),

(D) which is a part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of such taxpayer and his designated beneficiary,

(E) from a plan, contract, account, trust, or annuity described in subsection (e)(5)(D),

(F) allocable to investment in the contract before August 14, 1982, or (FOOTNOTE 3)

(FOOTNOTE 3) So in original. The word "or" probably should not appear.

(G) under a qualified funding asset (within the meaning of section 130(d), but without regard to whether there is a qualified assignment),

(H) to which subsection (t) applies (without regard to paragraph (2) thereof),

(I) under an immediate annuity contract (within the

meaning of section 72(u)(4)), or

(J) which is purchased by an employer upon the termination of a plan described in section 401(a) or 403(a) and which is held by the employer until such time as the employee separates from service.

(3) Change in substantially equal payments

If -

(A) paragraph (1) does not apply to a distribution by reason of paragraph (2)(D), and

(B) the series of payments under such paragraph are subsequently modified (other than by reason of death or disability) -

(i) before the close of the 5-year period beginning on the date of the first payment and after the taxpayer attains age 59 1/2, or

(ii) before the taxpayer attains age 59 1/2, the taxpayer's tax for the 1st taxable year in which such modification occurs shall be increased by an amount, determined under regulations, equal to the tax which (but for paragraph (2)(D)) would have been imposed, plus interest for the deferral period (within the meaning of subsection (t)(4)(B)).

(r) Certain railroad retirement benefits treated as received under employer plans

(1) In general

Notwithstanding any other provision of law, any benefit provided under the Railroad Retirement Act of 1974 (other than a tier 1 railroad retirement benefit) shall be treated for purposes of this title as a benefit provided under an employer plan which meets the requirements of section 401(a).

(2) Tier 2 taxes treated as contributions

(A) In general

For purposes of paragraph (1) -

(i) the tier 2 portion of the tax imposed by section 3201 (relating to tax on employees) shall be treated as an employee contribution,

(ii) the tier 2 portion of the tax imposed by section 3211

(relating to tax on employee representatives) shall be treated as an employee contribution, and

(iii) the tier 2 portion of the tax imposed by section 3221 (relating to tax on employers) shall be treated as an employer contribution.

(B) Tier 2 portion

For purposes of subparagraph (A) -

(i) After 1984

With respect to compensation paid after 1984, the tier 2 portion shall be the taxes imposed by sections 3201(b), 3211(a)(2), and 3221(b).

(ii) After September 30, 1981, and before 1985

With respect to compensation paid before 1985 for services rendered after September 30, 1981, the tier 2 portion shall be -

(I) so much of the tax imposed by section 3201 as is determined at the 2 percent rate, and

(II) so much of the taxes imposed by sections 3211 and 3221 as is determined at the 11.75 percent rate.

With respect to compensation paid for services rendered after December 31, 1983, and before 1985, subclause (I) shall be applied by substituting "2.75 percent" for "2 percent", and subclause (II) shall be applied by substituting "12.75 percent" for "11.75 percent".

(iii) Before October 1, 1981

With respect to compensation paid for services rendered during any period before October 1, 1981, the tier 2 portion shall be the excess (if any) of -

(I) the tax imposed for such period by section 3201, 3211, or 3221, as the case may be (other than any tax imposed with respect to man-hours), over

(II) the tax which would have been imposed by such section for such period had the rates of the comparable taxes imposed by chapter 21 for such period applied under such section.

(C) Contributions not allocable to supplemental annuity

or windfall benefits

For purposes of paragraph (1), no amount treated as an employee contribution under this paragraph shall be allocated to -

(i) any supplemental annuity paid under section 2(b) of the Railroad Retirement Act of 1974, or

(ii) any benefit paid under section 3(h), 4(e), or 4(h) of such Act.

(3) Tier 1 railroad retirement benefit

For purposes of paragraph (1), the term "tier 1 railroad retirement benefit" has the meaning given such term by section 86(d)(4).

(s) Required distributions where holder dies before entire interest is distributed

(1) In general

A contract shall not be treated as an annuity contract for purposes of this title unless it provides that -

(A) if any holder of such contract dies on or after the annuity starting date and before the entire interest in such contract has been distributed, the remaining portion of such interest will be distributed at least as rapidly as under the method of distributions being used as of the date of his death, and

(B) if any holder of such contract dies before the annuity starting date, the entire interest in such contract will be distributed within 5 years after the death of such holder.

(2) Exception for certain amounts payable over life of beneficiary

If -

(A) any portion of the holder's interest is payable to (or for the benefit of) a designated beneficiary,

(B) such portion will be distributed (in accordance with regulations) over the life of such designated beneficiary (or over a period not extending beyond the life expectancy of such beneficiary), and

(C) such distributions begin not later than 1 year after the

date of the holder's death or such later date as the Secretary may by regulations prescribe, then for purposes of paragraph (1), the portion referred to in subparagraph (A) shall be treated as distributed on the day on which such distributions begin.

(3) Special rule where surviving spouse beneficiary

If the designated beneficiary referred to in paragraph (2)(A) is the surviving spouse of the holder of the contract, paragraphs

(1) and (2) shall be applied by treating such spouse as the holder of such contract.

(4) Designated beneficiary

For purposes of this subsection, the term "designated beneficiary" means any individual designated a beneficiary by the holder of the contract.

(5) Exception for certain annuity contracts

This subsection shall not apply to any annuity contract -

(A) which is provided -

(i) under a plan described in section 401(a) which includes a trust exempt from tax under section 501, or

(ii) under a plan described in section 403(a),

(B) which is described in section 403(b),

(C) which is an individual retirement annuity or provided under an individual retirement account or annuity, or

(D) which is a qualified funding asset (as defined in section 130(d), but without regard to whether there is a qualified assignment).

(6) Special rule where holder is corporation or other non-individual

(A) In general

For purposes of this subsection, if the holder of the contract is not an individual, the primary annuitant shall be treated as the holder of the contract. -

(B) Primary annuitant

For purposes of subparagraph (A), the term "primary annuitant" means the individual, the events in the life of

whom are of primary importance in affecting the timing or amount of the payout under the contract.

(7) Treatment of changes in primary annuitant where holder of contract is not an individual

For purposes of this subsection, in the case of a holder of an annuity contract which is not an individual, if there is a change in a primary annuitant (as defined in paragraph (6)(B)), such change shall be treated as the death of the holder.

(t) 10-percent additional tax on early distributions from qualified retirement plans

(1) Imposition of additional tax

If any taxpayer receives any amount from a qualified retirement plan (as defined in section 4974(c)), the taxpayer's tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income.

(2) Subsection not to apply to certain distributions

Except as provided in paragraphs (3) and (4), paragraph (1) shall not apply to any of the following distributions:

(A) In general

Distributions which are -

(i) made on or after the date on which the employee attains age 59 1/2,

(ii) made to a beneficiary (or to the estate of the employee) on or after the death of the employee,

(iii) attributable to the employee's being disabled within the meaning of subsection (m)(7),

(iv) part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of such employee and his designated beneficiary,

(v) made to an employee after separation from service after attainment of age 55, or

(vi) dividends paid with respect to stock of a corporation which are described in section 404(k).

(B) Medical expenses

Distributions made to the employee (other than distributions described in subparagraph (A), (C), or (D)) to the extent such distributions do not exceed the amount allowable as a deduction under section 213 to the employee for amounts paid during the taxable year for medical care (determined without regard to whether the employee itemizes deductions for such taxable year).

(C) Payments to alternate payees pursuant to qualified domestic relations orders

Any distribution to an alternate payee pursuant to a qualified domestic relations order (within the meaning of section 414(p)(1)).

(D) Distributions to unemployed individuals for health insurance premiums

(i) In general

Distributions from an individual retirement plan to an individual after separation from employment -

(I) if such individual has received unemployment compensation for 12 consecutive weeks under any Federal or State unemployment compensation law by reason of such separation,

(II) if such distributions are made during any taxable year during which such unemployment compensation is paid or the succeeding taxable year, and

(III) to the extent such distributions do not exceed the amount paid during the taxable year for insurance described in section 213(d)(1)(D) with respect to the individual and the individual's spouse and dependents (as defined in section 152).

(ii) Distributions after reemployment

Clause (i) shall not apply to any distribution made after the individual has been employed for at least 60 days after the separation from employment to which clause (i) applies.

(iii) Self-employed individuals

To the extent provided in regulations, a self-employed individual shall be treated as meeting the requirements of clause (i)(I) if, under Federal or State law, the individual would have received unemployment compensation but for the fact the individual was self-employed.

(3) Limitations

(A) Certain exceptions not to apply to individual retirement plans

Subparagraphs (A)(v), (FOOTNOTE 4) and (C) of paragraph (2) shall not apply to distributions from an individual retirement plan.

(FOOTNOTE 4) So in original. The comma probably should not appear.

(B) Periodic payments under qualified plans must begin after separation

Paragraph (2)(A)(iv) shall not apply to any amount paid from a trust described in section 401(a) which is exempt from tax under section 501(a) or from a contract described in section 72(e)(5)(D)(ii) unless the series of payments begins after the employee separates from service.

(4) Change in substantially equal payments

(A) In general

If -

(i) paragraph (1) does not apply to a distribution by reason of paragraph (2)(A)(iv), and

(ii) the series of payments under such paragraph are subsequently modified (other than by reason of death or disability) -

(I) before the close of the 5-year period beginning with the date of the first payment and after the employee attains age 59 1/2, or

(II) before the employee attains age 59 1/2, the taxpayer's tax for the 1st taxable year in which such modification occurs shall be increased by an amount, determined under regulations, equal to the tax which (but for paragraph

(2)(A)(iv)) would have been imposed, plus interest for the deferral period.

(B) Deferral period

For purposes of this paragraph, the term "deferral period" means the period beginning with the taxable year in which (without regard to paragraph (2)(A)(iv)) the distribution would have been includible in gross income and ending with the taxable year in which the modification described in subparagraph (A) occurs.

(5) Employee

For purposes of this subsection, the term "employee" includes any participant, and in the case of an individual retirement plan, the individual for whose benefit such plan was established.

(6) Special rules for simple retirement accounts

In the case of any amount received from a simple retirement account (within the meaning of section 408(p)) during the 2-year period beginning on the date such individual first participated in any qualified salary reduction arrangement maintained by the individual's employer under section 408(p)(2), paragraph (1) shall be applied by substituting "25 percent" for "10 percent".

(u) Treatment of annuity contracts not held by natural persons

(1) In general

If any annuity contract is held by a person who is not a natural person -

(A) such contract shall not be treated as an annuity contract for purposes of this subtitle (other than subchapter L), and

(B) the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the owner during such taxable year.

For purposes of this paragraph, holding by a trust or other entity as an agent for a natural person shall not be taken into account.

(2) Income on the contract

(A) In general

For purposes of paragraph (1), the term "income on the contract" means, with respect to any taxable year of the policyholder, the excess of -

(i) the sum of the net surrender value of the contract as of the close of the taxable year plus all distributions under the contract received during the taxable year or any prior taxable year, reduced by

(ii) the sum of the amount of net premiums under the contract for the taxable year and prior taxable years and amounts includible in gross income for prior taxable years with respect to such contract under this subsection.

Where necessary to prevent the avoidance of this subsection, the Secretary may substitute "fair market value of the contract" for "net surrender value of the contract" each place it appears in the preceding sentence.

(B) Net premiums

For purposes of this paragraph, the term "net premiums" means the amount of premiums paid under the contract reduced by any policyholder dividends.

(3) Exceptions

This subsection shall not apply to any annuity contract which -

(A) is acquired by the estate of a decedent by reason of the death of the decedent,

(B) is held under a plan described in section 401(a) or 403(a), under a program described in section 403(b), or under an individual retirement plan,

(C) is a qualified funding asset (as defined in section 130(d), but without regard to whether there is a qualified assignment),

(D) is purchased by an employer upon the termination of a plan described in section 401(a) or 403(a) and is held by the employer until all amounts under such contract are distributed to the employee for whom such contract was

purchased or the employee's beneficiary, or

(E) is an immediate annuity.

(4) Immediate annuity

For purposes of this subsection, the term "immediate annuity" means an annuity -

(A) which is purchased with a single premium or annuity consideration,

(B) the annuity starting date (as defined in subsection (c)(4)) of which commences no later than 1 year from the date of the purchase of the annuity, and

(C) which provides for a series of substantially equal periodic payments (to be made not less frequently than annually) during the annuity period.

(v) 10-percent additional tax for taxable distributions from modified endowment contracts

(1) Imposition of additional tax

If any taxpayer receives any amount under a modified endowment contract (as defined in section 7702A), the taxpayer's tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income.

(2) Subsection not to apply to certain distributions

Paragraph (1) shall not apply to any distribution -

(A) made on or after the date on which the taxpayer attains age 59 1/2,

(B) which is attributable to the taxpayer's becoming disabled (within the meaning of subsection (m)(7)), or

(C) which is part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of such taxpayer and his beneficiary.

(w) Cross reference

For limitation on adjustments to basis of annuity contracts sold, see section 1021.

26 U.S.C. § 401 Qualified pension, profit-sharing, and stock bonus plans

(a) Requirements for qualification

A trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section -

(1) if contributions are made to the trust by such employer, or employees, or both, or by another employer who is entitled to deduct his contributions under section 404(a)(3)(B) (relating to deduction for contributions to profit-sharing and stock bonus plans), for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with such plan;

(2) if under the trust instrument it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries (but this paragraph shall not be construed, in the case of a multiemployer plan, to prohibit the return of a contribution within 6 months after the plan administrator determines that the contribution was made by a mistake of fact or law (other than a mistake relating to whether the plan is described in section 401(a) or the trust which is part of such plan is exempt from taxation under section 501(a), or the return of any withdrawal liability payment determined to be an overpayment within 6 months of such determination).; (FOOTNOTE 1)

(FOOTNOTE 1) So in original. Period before semicolon probably should be a closing parenthesis.

(3) if the plan of which such trust is a part satisfies the

requirements of section 410 (relating to minimum participation standards); and

(4) if the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees (within the meaning of section 414(q)). For purposes of this paragraph, there shall be excluded from consideration employees described in section 410(b)(3)(A) and (C).

(5) Special rules relating to nondiscrimination requirements. -

(A) Salaried or clerical employees. - A classification shall not be considered discriminatory within the meaning of paragraph (4) or section 410(b)(2)(A)(i) merely because it is limited to salaried or clerical employees.

(B) Contributions and benefits may bear uniform relationship to compensation. - A plan shall not be considered discriminatory within the meaning of paragraph (4) merely because the contributions or benefits of, or on behalf of, the employees under the plan bear a uniform relationship to the compensation (within the meaning of section 414(s)) of such employees.

(C) Certain disparity permitted. - A plan shall not be considered discriminatory within the meaning of paragraph (4) merely because the contributions or benefits of, or on behalf of, the employees under the plan favor highly compensated employees (as defined in section 414(q)) in the manner permitted under subsection (l).

(D) Integrated defined benefit plan. -

(i) In general. - A defined benefit plan shall not be considered discriminatory within the meaning of paragraph (4) merely because the plan provides that the employer-derived accrued retirement benefit for any participant under the plan may not exceed the excess (if any) of -

(I) the participant's final pay with the employer, over

(II) the employer-derived retirement benefit created under Federal law attributable to service by the participant

with the employer.

For purposes of this clause, the employer-derived retirement benefit created under Federal law shall be treated as accruing ratably over 35 years.

(ii) Final pay. - For purposes of this subparagraph, the participant's final pay is the compensation (as defined in section 414(q)(7)) paid to the participant by the employer for any year -

(I) which ends during the 5-year period ending with the year in which the participant separated from service for the employer, and

(II) for which the participant's total compensation from the employer was highest.

(E) 2 or more plans treated as single plan. - For purposes of determining whether 2 or more plans of an employer satisfy the requirements of paragraph (4) when considered as a single plan -

(i) Contributions. - If the amount of contributions on behalf of the employees allowed as a deduction under section 404 for the taxable year with respect to such plans, taken together, bears a uniform relationship to the compensation (within the meaning of section 414(s)) of such employees, the plans shall not be considered discriminatory merely because the rights of employees to, or derived from, the employer contributions under the separate plans do not become nonforfeitable at the same rate.

(ii) Benefits. - If the employees' rights to benefits under the separate plans do not become nonforfeitable at the same rate, but the levels of benefits provided by the separate plans satisfy the requirements of regulations prescribed by the Secretary to take account of the differences in such rates, the plans shall not be considered discriminatory merely because of the difference in such rates.

(6) A plan shall be considered as meeting the requirements of paragraph (3) during the whole of any taxable year of the plan if on one day in each quarter it

satisfied such requirements.

(7) A trust shall not constitute a qualified trust under this section unless the plan of which such trust is a part satisfies the requirements of section 411 (relating to minimum vesting standards).

(8) A trust forming part of a defined benefit plan shall not constitute a qualified trust under this section unless the plan provides that forfeitures must not be applied to increase the benefits any employee would otherwise receive under the plan.

(9) Required distributions. -

(A) In general. - A trust shall not constitute a qualified trust under this subsection unless the plan provides that the entire interest of each employee -

(i) will be distributed to such employee not later than the required beginning date, or

(ii) will be distributed, beginning not later than the required beginning date, in accordance with regulations, over the life of such employee or over the lives of such employee and a designated beneficiary (or over a period not extending beyond the life expectancy of such employee or the life expectancy of such employee and a designated beneficiary).

(B) Required distribution where employee dies before entire interest is distributed. -

(i) Where distributions have begun under subparagraph (A)(ii). - A trust shall not constitute a qualified trust under this section unless the plan provides that if -

(I) the distribution of the employee's interest has begun in accordance with subparagraph (A)(ii), and

(II) the employee dies before his entire interest has been distributed to him, the remaining portion of such interest will be distributed at least as rapidly as under the method of distributions being used under subparagraph (A)(ii) as of the date of his death.

(ii) 5-year rule for other cases. - A trust shall not constitute a qualified trust under this section unless the plan

provides that, if an employee dies before the distribution of the employee's interest has begun in accordance with subparagraph (A)(ii), the entire interest of the employee will be distributed within 5 years after the death of such employee.

(iii) Exception to 5-year rule for certain amounts payable over life of beneficiary. - If -

(I) any portion of the employee's interest is payable to (or for the benefit of) a designated beneficiary,

(II) such portion will be distributed (in accordance with regulations) over the life of such designated beneficiary (or over a period not extending beyond the life expectancy of such beneficiary), and

(III) such distributions begin not later than 1 year after the date of the employee's death or such later date as the Secretary may by regulations prescribe, for purposes of clause (ii), the portion referred to in subclause (I) shall be treated as distributed on the date on which such distributions begin.

(iv) Special rule for surviving spouse of employee. - If the designated beneficiary referred to in clause (iii)(I) is the surviving spouse of the employee -

(I) the date on which the distributions are required to begin under clause (iii)(III) shall not be earlier than the date on which the employee would have attained age 70 1/2, and

(II) if the surviving spouse dies before the distributions to such spouse begin, this subparagraph shall be applied as if the surviving spouse were the employee.

(C) Required beginning date. - For purposes of this paragraph, the term "required beginning date" means April 1 of the calendar year following the calendar year in which the employee attains age 70 1/2. In the case of a governmental plan or church plan, the required beginning date shall be the later of the date determined under the preceding sentence or April 1 of the calendar year following the calendar year in which the employee retires. For purposes of this

subparagraph, the term

"church plan" means a plan maintained by a church for church employees, and the term "church" means any church (as defined in section 3121(w)(3)(A)) or qualified church-controlled organization (as defined in section 3121(w)(3)(B)).

(D) Life expectancy. - For purposes of this paragraph, the life expectancy of an employee and the employee's spouse (other than in the case of a life annuity) may be redetermined but not more frequently than annually.

(E) Designated beneficiary. - For purposes of this paragraph, the term "designated beneficiary" means any individual designated as a beneficiary by the employee.

(F) Treatment of payments to children. - Under regulations prescribed by the Secretary, for purposes of this paragraph, any amount paid to a child shall be treated as if it had been paid to the surviving spouse if such amount will become payable to the surviving spouse upon such child reaching majority (or other designated event permitted under regulations).

(G) Treatment of incidental death benefit distributions. -

For purposes of this title, any distribution required under the incidental death benefit requirements of this subsection shall be treated as a distribution required under this paragraph.

(10) Other requirements. -

(A) Plans benefiting owner-employees. - In the case of any plan which provides contributions or benefits for employees some or all of whom are owner-employees (as defined in subsection (c)(3)), a trust forming part of such plan shall constitute a qualified trust under this section only if the requirements of subsection (d) are also met.

(B) Top-heavy plans. -

(i) In general. - In the case of any top-heavy plan, a trust forming part of such plan shall constitute a qualified trust under this section only if the requirements of section 416 are

met.

(ii) Plans which may become top-heavy. - Except to the extent provided in regulations, a trust forming part of a plan (whether or not a top-heavy plan) shall constitute a qualified trust under this section only if such plan contains provisions -

(I) which will take effect if such plan becomes a top-heavy plan, and

(II) which meet the requirements of section 416.

(iii) Exemption for governmental plans. - This subparagraph shall not apply to any governmental plan.

(11) Requirement of joint and survivor annuity and preretirement survivor annuity. -

(A) In general. - In the case of any plan to which this paragraph applies, except as provided in section 417, a trust forming part of such plan shall not constitute a qualified trust under this section unless -

(i) in the case of a vested participant who does not die before the annuity starting date, the accrued benefit payable to such participant is provided in the form of a qualified joint and survivor annuity, and

(ii) in the case of a vested participant who dies before the annuity starting date and who has a surviving spouse, a qualified preretirement survivor annuity is provided to the surviving spouse of such participant.

(B) Plans to which paragraph applies. - This paragraph shall apply to -

(i) any defined benefit plan,

(ii) any defined contribution plan which is subject to the funding standards of section 412, and

(iii) any participant under any other defined contribution plan unless -

(I) such plan provides that the participant's nonforfeitable accrued benefit (reduced by any security interest held by the plan by reason of a loan outstanding to such participant) is payable in full, on the death of the participant, to the participant's surviving spouse (or, if there is no surviving

spouse or the surviving spouse consents in the manner required under section 417(a)(2), to a designated beneficiary),

(II) such participant does not elect a payment of benefits in the form of a life annuity, and

(III) with respect to such participant, such plan is not a direct or indirect transferee (in a transfer after December 31, 1984) of a plan which is described in clause (i) or (ii) or to which this clause applied with respect to the participant.

Clause (iii)(III) shall apply only with respect to the transferred assets (and income therefrom) if the plan separately accounts for such assets and any income therefrom.

(C) Exception for certain ESOP benefits. -

(i) In general. - In the case of -

(I) a tax credit employee stock ownership plan (as defined in section 409(a)), or

(II) an employee stock ownership plan (as defined in section 4975(e)(7)), subparagraph (A) shall not apply to that portion of the employee's accrued benefit to which the requirements of section 409(h) apply.

(ii) Nonforfeitable benefit must be paid in full, etc. - In the case of any participant, clause (i) shall apply only if the requirements of subclauses (I), (II), and (III) of subparagraph (B)(iii) are met with respect to such participant.

(D) Special rule where participant and spouse married less than 1 year. - A plan shall not be treated as failing to meet the requirements of subparagraphs (B)(iii) or (C) merely because the plan provides that benefits will not be payable to the surviving spouse of the participant unless the participant and such spouse had been married throughout the 1-year period ending on the earlier of the participant's annuity starting date or the date of the participant's death.

(E) Exception for plans described in section 404(c). - This paragraph shall not apply to a plan which the Secretary has determined is a plan described in section 404(c) (or a

continuation thereof) in which participation is substantially limited to individuals who, before January 1, 1976, ceased employment covered by the plan.

(F) Cross reference. - For -

(i) provisions under which participants may elect to waive the requirements of this paragraph, and

(ii) other definitions and special rules for purposes of this paragraph, see section 417.

(12) A trust shall not constitute a qualified trust under this section unless the plan of which such trust is a part provides that in the case of any merger or consolidation with, or transfer of assets or liabilities to, any other plan after September 2, 1974, each participant in the plan would (if the plan then terminated) receive a benefit immediately after the merger, consolidation, or transfer which is equal to or greater than the benefit he would have been entitled to receive immediately before the merger, consolidation, or transfer (if the plan had then terminated). The preceding sentence does not apply to any multiemployer plan with respect to any transaction to the extent that participants either before or after the transaction are covered under a multiemployer plan to which title IV of the Employee Retirement Income Security Act of 1974 applies.

(13) Assignment and alienation. -

(A) In general. - A trust shall not constitute a qualified trust under this section unless the plan of which such trust is a part provides that benefits provided under the plan may not be assigned or alienated. For purposes of the preceding sentence, there shall not be taken into account any voluntary and revocable assignment of not to exceed 10 percent of any benefit payment made by any participant who is receiving benefits under the plan unless the assignment or alienation is made for purposes of defraying plan administration costs. For purposes of this paragraph a loan made to a participant or beneficiary shall not be treated as an assignment or alienation if such loan is secured by the participant's accrued

nonforfeitable benefit and is exempt from the tax imposed by section 4975 (relating to tax on prohibited transactions) by reason of section 4975(d)(1). This paragraph shall take effect on January 1, 1976 and shall not apply to assignments which were irrevocable on September 2, 1974.

(B) Special rules for domestic relations orders. -

Subparagraph (A) shall apply to the creation, assignment, or recognition of a right to any benefit payable with respect to a participant pursuant to a domestic relations order, except that subparagraph (A) shall not apply if the order is determined to be a qualified domestic relations order.

(14) A trust shall not constitute a qualified trust under this section unless the plan of which such trust is a part provides that, unless the participant otherwise elects, the payment of benefits under the plan to the participant will begin not later than the 60th day after the latest of the close of the plan year in which -

(A) the date on which the participant attains the earlier of age 65 or the normal retirement age specified under the plan,

(B) occurs the 10th anniversary of the year in which the participant commenced participation in the plan, or

(C) the participant terminates his service with the employer.

In the case of a plan which provides for the payment of an early retirement benefit, a trust forming a part of such plan shall not constitute a qualified trust under this section unless a participant who satisfied the service requirements for such early retirement benefit, but separated from the service (with any nonforfeitable right to an accrued benefit) before satisfying the age requirement for such early retirement benefit, is entitled upon satisfaction of such age requirement to receive a benefit not less than the benefit to which he would be entitled at the normal retirement age, actuarially, reduced under regulations prescribed by the Secretary.

(15) a trust shall not constitute a qualified trust under this section unless under the plan of which such trust is a part -

(A) in the case of a participant or beneficiary who is receiving benefits under such plan, or

(B) in the case of a participant who is separated from the service and who has nonforfeitable rights to benefits, such benefits are not decreased by reason of any increase in the benefit levels payable under title II of the Social Security Act or any increase in the wage base under such title II, if such increase takes place after September 2, 1974, or (if later) the earlier of the date of first receipt of such benefits or the date of such separation, as the case may be.

(16) A trust shall not constitute a qualified trust under this section if the plan of which such trust is a part provides for benefits or contributions which exceed the limitations of section 415.

(17) Compensation limit. -

(A) In general. - A trust shall not constitute a qualified trust under this section unless, under the plan of which such trust is a part, the annual compensation of each employee taken into account under the plan for any year does not exceed $150,000. In determining the compensation of an employee, the rules of section 414(q)(6) shall apply, except that in applying such rules, the term "family" shall include only the spouse of the employee and any lineal descendants of the employee who have not attained age 19 before the close of the year.

(B) Cost-of-living adjustment. - The Secretary shall adjust annually the $150,000 amount in subparagraph (A) for increases in the cost-of-living at the same time and in the same manner as adjustments under section 415(d); except that the base period shall be the calendar quarter beginning October 1, 1993, and any increase which is not a multiple of $10,000 shall be rounded to the next lowest multiple of $10,000.

((18) Repealed. Pub. L. 97-248, title II, Sec. 237(b), Sept. 3, 1982, 96 Stat. 511.)

(19) A trust shall not constitute a qualified trust under

this section if under the plan of which such trust is a part any part of a participant's accrued benefit derived from employer contributions (whether or not otherwise nonforfeitable), is forfeitable solely because of withdrawal by such participant of any amount attributable to the benefit derived from contributions made by such participant. The preceding sentence shall not apply to the accrued benefit of any participant unless, at the time of such withdrawal, such participant has a nonforfeitable right to at least 50 percent of such accrued benefit (as determined under section 411). The first sentence of this paragraph shall not apply to the extent that an accrued benefit is permitted to be forfeited in accordance with section 411(a)(3)(D)(iii) (relating to proportional forfeitures of benefits accrued before September 2, 1974, in the event of withdrawal of certain mandatory contributions).

(20) A trust forming part of a pension plan shall not be treated as failing to constitute a qualified trust under this section merely because the pension plan of which such trust is a part makes 1 or more distributions within 1 taxable year to a distributee on account of a termination of the plan of which the trust is a part, or in the case of a profit-sharing or stock bonus plan, a complete discontinuance of contributions under such plan. This paragraph shall not apply to a defined benefit plan unless the employer maintaining such plan files a notice with the Pension Benefit Guaranty Corporation (at the time and in the manner prescribed by the Pension Benefit Guaranty Corporation) notifying the Corporation of such payment or distribution and the Corporation has approved such payment or distribution or, within

90 days after the date on which such notice was filed, has failed to disapprove such payment or distribution. For purposes of this paragraph, rules similar to the rules of section 402(a)(6)(B) (as in effect before its repeal by section 211 (FOOTNOTE 2) of the Unemployment Compensation Amendments of 1992) shall apply.

(FOOTNOTE 2) See References in Text note below.

((21) Repealed. Pub. L. 99-514, title XI, Sec. 1171(b)(5), Oct. 22, 1986, 100 Stat. 2513.)

(22) If a defined contribution plan (other than a profit-sharing plan) -

(A) is established by an employer whose stock is not readily tradable on an established market, and

(B) after acquiring securities of the employer, more than 10 percent of the total assets of the plan are securities of the employer, any trust forming part of such plan shall not constitute a qualified trust under this section unless the plan meets the requirements of subsection (e) of section 409. The requirements of subsection (e) of section 409 shall not apply to any employees of an employer who are participants in any defined contribution plan established and maintained by such employer if the stock of such employer is not readily tradable on an established market and the trade or business of such employer consists of publishing on a regular basis a newspaper for general circulation. For purposes of the preceding sentence, subsections (b), (c), (m), and (o) of section 414 shall not apply except for determining whether stock of the employer is not readily tradable on an established market.

(23) A stock bonus plan shall not be treated as meeting the requirements of this section unless such plan meets the requirements of subsections (h) and (o) of section 409, except that in applying section 409(h) for purposes of this paragraph, the term "employer securities" shall include any securities of the employer held by the plan.

(24) Any group trust which otherwise meets the requirements of this section shall not be treated as not meeting such requirements on account of the participation or inclusion in such trust of the moneys of any plan or governmental unit described in section 818(a)(6).

(25) Requirement that actuarial assumptions be specified. - A defined benefit plan shall not be treated as providing

definitely determinable benefits unless, whenever the amount of any benefit is to be determined on the basis of actuarial assumptions, such assumptions are specified in the plan in a way which precludes employer discretion.

(26) Additional participation requirements. -

(A) In general. - A trust shall not constitute a qualified trust under this subsection unless such trust is part of a plan which on each day of the plan year benefits the lesser of -

(i) 50 employees of the employer, or

(ii) 40 percent or more of all employees of the employer.

(B) Treatment of excludable employees. -

(i) In general. - A plan may exclude from consideration under this paragraph employees described in paragraphs (3) and (4)(A) of section 410(b).

(ii) Separate application for certain excludable employees.

- If employees described in section 410(b)(4)(B) are covered under a plan which meets the requirements of subparagraph (A) separately with respect to such employees, such employees may be excluded from consideration in determining whether any plan of the employer meets such requirements if -

(I) the benefits for such employees are provided under the same plan as benefits for other employees,

(II) the benefits provided to such employees are not greater than comparable benefits provided to other employees under the plan, and

(III) no highly compensated employee (within the meaning of section 414(q)) is included in the group of such employees for more than 1 year.

(C) Eligibility to participate. - In the case of contributions under section 401(k) or 401(m), employees who are eligible to contribute (or may elect to have contributions made on their behalf) shall be treated as benefiting under the plan.

(D) Special rule for collective bargaining units. - Except to the extent provided in regulations, a plan covering only

employees described in section 410(b)(3)(A) may exclude from consideration any employees who are not included in the unit or units in which the covered employees are included.

(E) Paragraph not to apply to multiemployer plans. - Except to the extent provided in regulations, this paragraph shall not apply to employees in a multiemployer plan (within the meaning of section 414(f)) who are covered by collective bargaining agreements.

(F) Special rule for certain dispositions or acquisitions. -

Rules similar to the rules of section 410(b)(6)(C) shall apply for purposes of this paragraph.

(G) Separate lines of business. - At the election of the employer and with the consent of the Secretary, this paragraph may be applied separately with respect to each separate line of business of the employer. For purposes of this paragraph, the term "separate line of business" has the meaning given such term by section 414(r) (without regard to paragraph (7) thereof).

(H) Special rule for certain police or firefighters. -

(i) In general. - An employer may elect to have this paragraph applied separately with respect to any classification of qualified public safety employees for whom a separate plan is maintained.

(ii) Qualified public safety employee. - For purposes of this subparagraph, the term "qualified public safety employee" means any employee of any police department or fire department organized and operated by a State or political subdivision if the employee provides police protection, firefighting services, or emergency medical services for any area within the jurisdiction of such State or political subdivision.

(I) Regulations. - The Secretary may by regulation provide that any separate benefit structure, any separate trust, or any other separate arrangement is to be treated as a separate plan for purposes of applying this paragraph.

(27) Determinations as to profit-sharing plans. -

(A) Contributions need not be based on profits. - The determination of whether the plan under which any contributions are made is a profit-sharing plan shall be made without regard to current or accumulated profits of the employer and without regard to whether the employer is a tax-exempt organization.

(B) Plan must designate type. - In the case of a plan which is intended to be a money purchase pension plan or a profit-sharing plan, a trust forming part of such plan shall not constitute a qualified trust under this subsection unless the plan designates such intent at such time and in such manner as the Secretary may prescribe.

(28) Additional requirements relating to employee stock ownership plans. -

(A) In general. - In the case of a trust which is part of an employee stock ownership plan (within the meaning of section 4975(e)(7)) or a plan which meets the requirements of section 409(a), such trust shall not constitute a qualified trust under this section unless such plan meets the requirements of subparagraphs (B) and (C).

(B) Diversification of investments. -

(i) In general. - A plan meets the requirements of this subparagraph if each qualified participant in the plan may elect within 90 days after the close of each plan year in the qualified election period to direct the plan as to the investment of at least 25 percent of the participant's account in the plan (to the extent such portion exceeds the amount to which a prior election under this subparagraph applies). In the case of the election year in which the participant can make his last election, the preceding sentence shall be applied by substituting "50 percent" for "25 percent".

(ii) Method of meeting requirements. - A plan shall be treated as meeting the requirements of clause (i) if -

(I) the portion of the participant's account covered by the election under clause (i) is distributed within 90 days after

the period during which the election may be made, or

(II) the plan offers at least 3 investment options (not inconsistent with regulations prescribed by the Secretary) to each participant making an election under clause (i) and within 90 days after the period during which the election may be made, the plan invests the portion of the participant's account covered by the election in accordance with such election.

(iii) Qualified participant. - For purposes of this subparagraph, the term "qualified participant" means any employee who has completed at least 10 years of participation under the plan and has attained age 55.

(iv) Qualified election period. - For purposes of this subparagraph, the term "qualified election period" means the 6-plan-year period beginning with the later of -

(I) the 1st plan year in which the individual first became a qualified participant, or

(II) the 1st plan year beginning after December 31, 1986.

For purposes of the preceding sentence, an employer may elect to treat an individual first becoming a qualified participant in the 1st plan year beginning in 1987 as having become a participant in the 1st plan year beginning in 1988.

(v) Coordination with distribution rules. - Any distribution required by this subparagraph shall not be taken into account in determining whether a subsequent distribution is a lump sum distribution under section 402(d)(4)(A) or in determining whether section 402(c)(10) applies.

(C) Use of independent appraiser. - A plan meets the requirements of this subparagraph if all valuations of employer securities which are not readily tradable on an established securities market with respect to activities carried on by the plan are by an independent appraiser. For purposes of the preceding sentence, the term "independent appraiser" means any appraiser meeting requirements similar to the requirements of the regulations prescribed under section

170(a)(1).

(29) Security required upon adoption of plan amendment resulting in significant underfunding. -

(A) In general. - If -

(i) a defined benefit plan (other than a multiemployer plan) to which the requirements of section 412 apply adopts an amendment an effect of which is to increase current liability under the plan for a plan year, and

(ii) the funded current liability percentage of the plan for the plan year in which the amendment takes effect is less than 60 percent, including the amount of the unfunded current liability under the plan attributable to the plan amendment, the trust of which such plan is a part shall not constitute a qualified trust under this subsection unless such amendment does not take effect until the contributing sponsor (or any member of the controlled group of the contributing sponsor) provides security to the plan.

(B) Form of security. - The security required under subparagraph (A) shall consist of -

(i) a bond issued by a corporate surety company that is an acceptable surety for purposes of section 412 of the Employee

Retirement Income Security Act of 1974,

(ii) cash, or United States obligations which mature in 3 years or less, held in escrow by a bank or similar financial institution, or

(iii) such other form of security as is satisfactory to the Secretary and the parties involved.

(C) Amount of security. - The security shall be in an amount equal to the excess of -

(i) the lesser of -

(I) the amount of additional plan assets which would be necessary to increase the funded current liability percentage under the plan to 60 percent, including the amount of the unfunded current liability under the plan attributable to the plan amendment, or

(II) the amount of the increase in current liability under the plan attributable to the plan amendment and any other plan amendments adopted after December 22, 1987, and before such plan amendment, over

(ii) $10,000,000.

(D) Release of security. - The security shall be released (and any amounts thereunder shall be refunded together with any interest accrued thereon) at the end of the first plan year which ends after the provision of the security and for which the funded current liability percentage under the plan is not less than 60 percent. The Secretary may prescribe regulations for partial releases of the security by reason of increases in the funded current liability percentage.

(E) Definitions. - For purposes of this paragraph, the terms "current liability", "funded current liability percentage", and "unfunded current liability" shall have the meanings given such terms by section 412(l), except that in computing unfunded current liability there shall not be taken into account any unamortized portion of the unfunded old liability amount as of the close of the plan year.

(30) Limitations on elective deferrals. - In the case of a trust which is part of a plan under which elective deferrals (within the meaning of section 402(g)(3)) may be made with respect to any individual during a calendar year, such trust shall not constitute a qualified trust under this subsection unless the plan provides that the amount of such deferrals under such plan and all other plans, contracts, or arrangements of an employer maintaining such plan may not exceed the amount of the limitation in effect under section 402(g)(1) for taxable years beginning in such calendar year.

(31) Optional direct transfer of eligible rollover distributions. -

(A) In general. - A trust shall not constitute a qualified trust under this section unless the plan of which such trust is a part provides that if the distributee of any eligible rollover

distribution -

(i) elects to have such distribution paid directly to an eligible retirement plan, and

(ii) specifies the eligible retirement plan to which such distribution is to be paid (in such form and at such time as the plan administrator may prescribe), such distribution shall be made in the form of a direct trustee-to-trustee transfer to the eligible retirement plan so specified.

(B) Limitation. - Subparagraph (A) shall apply only to the extent that the eligible rollover distribution would be includible in gross income if not transferred as provided in subparagraph (A) (determined without regard to sections 402(c) and 403(a)(4)).

(C) Eligible rollover distribution. - For purposes of this paragraph, the term "eligible rollover distribution" has the meaning given such term by section 402(f)(2)(A).

(D) Eligible retirement plan. - For purposes of this paragraph, the term "eligible retirement plan" has the meaning given such term by section 402(c)(8)(B), except that a qualified trust shall be considered an eligible retirement plan only if it is a defined contribution plan, the terms of which permit the acceptance of rollover distributions.

(32) Treatment of failure to make certain payments if plan has liquidity shortfall. -

(A) In general. - A trust forming part of a pension plan to which section 412(m)(5) applies shall not be treated as failing to constitute a qualified trust under this section merely because such plan ceases to make any payment described in subparagraph (B) during any period that such plan has a liquidity shortfall (as defined in section 412(m)(5)).

(B) Payments described. - A payment is described in this subparagraph if such payment is -

(i) any payment, in excess of the monthly amount paid under a single life annuity (plus any social security supplements described in the last sentence of section 411(a)(9)), to a participant or beneficiary whose annuity

starting date (as defined in section 417(f)(2)) occurs during the period referred to in subparagraph (A),

(ii) any payment for the purchase of an irrevocable commitment from an insurer to pay benefits, and

(iii) any other payment specified by the Secretary by regulations.

(C) Period of shortfall. - For purposes of this paragraph, a plan has a liquidity shortfall during the period that there is an underpayment of an installment under section 412(m) by reason of paragraph (5)(A) thereof.

(33) Prohibition on benefit increases while sponsor is in bankruptcy. -

(A) In general. - A trust which is part of a plan to which this paragraph applies shall not constitute a qualified trust under this section if an amendment to such plan is adopted while the employer is a debtor in a case under title 11, United States Code, or similar Federal or State law, if such amendment increases liabilities of the plan by reason of -

(i) any increase in benefits,

(ii) any change in the accrual of benefits, or

(iii) any change in the rate at which benefits become nonforfeitable under the plan, with respect to employees of the debtor, and such amendment is effective prior to the effective date of such employer's plan of reorganization.

(B) Exceptions. - This paragraph shall not apply to any plan amendment if -

(i) the plan, were such amendment to take effect, would have a funded current liability percentage (as defined in section 412(l)(8)) of 100 percent or more,

(ii) the Secretary determines that such amendment is reasonable and provides for only de minimis increases in the liabilities of the plan with respect to employees of the debtor,

(iii) such amendment only repeals an amendment described in subsection 412(c)(8), or

(iv) such amendment is required as a condition of qualification under this part.

(C) Plans to which this paragraph applies. - This paragraph shall apply only to plans (other than multiemployer plans) covered under section 4021 of the Employee Retirement Income Security Act of 1974.

(D) Employer. - For purposes of this paragraph, the term "employer" means the employer referred to in section 412(c)(11) (without regard to subparagraph (B) thereof).

(34) Benefits of missing participants on plan termination. - In the case of a plan covered by title IV of the Employee Retirement Income Security Act of 1974, a trust forming part of such plan shall not be treated as failing to constitute a qualified trust under this section merely because the pension plan of which such trust is a part, upon its termination, transfers benefits of missing participants to the Pension Benefit Guaranty Corporation in accordance with section 4050 of such Act.

Paragraphs (11), (12), (13), (14), (15), (19), and (20) shall apply only in the case of a plan to which section 411 (relating to minimum vesting standards) applies without regard to subsection (e)(2) of such section.

(b) Certain retroactive changes in plan

A stock bonus, pension, profit-sharing, or annuity plan shall be considered as satisfying the requirements of subsection (a) for the period beginning with the date on which it was put into effect, or for the period beginning with the earlier of the date on which there was adopted or put into effect any amendment which caused the plan to fail to satisfy such requirements, and ending with the time prescribed by law for filing the return of the employer for his taxable year in which such plan or amendment was adopted (including extensions thereof) or such later time as the Secretary may designate, if all provisions of the plan which are necessary to satisfy such requirements are in effect by the end of such period and have been made effective for all purposes for the whole of such period.

(c) Definitions and rules relating to self-employed

individuals and owner-employees

For purposes of this section -

(1) Self-employed individual treated as employee

(A) In general

The term "employee" includes, for any taxable year, an individual who is a self-employed individual for such taxable year.

(B) Self-employed individual

The term "self-employed individual" means, with respect to any taxable year, an individual who has earned income (as defined in paragraph (2)) for such taxable year. To the extent provided in regulations prescribed by the Secretary, such term also includes, for any taxable year -

(i) an individual who would be a self-employed individual within the meaning of the preceding sentence but for the fact that the trade or business carried on by such individual did not have net profits for the taxable year, and

(ii) an individual who has been a self-employed individual within the meaning of the preceding sentence for any prior taxable year.

(2) Earned income

(A) In general

The term "earned income" means the net earnings from self-employment (as defined in section 1402(a)), but such net earnings shall be determined -

(i) only with respect to a trade or business in which personal services of the taxpayer are a material income-producing factor,

(ii) without regard to paragraphs (4) and (5) of section 1402(c),

(iii) in the case of any individual who is treated as an employee under sections (FOOTNOTE 3) 3121(d)(3)(A), (C), or

(D), without regard to paragraph (2) of section 1402(c),

(FOOTNOTE 3) So in original. Probably should be "section".

(iv) without regard to items which are not included in gross income for purposes of this chapter, and the deductions properly allocable to or chargeable against such items,

(v) with regard to the deductions allowed by section 404 to the taxpayer, and

(vi) with regard to the deduction allowed to the taxpayer by section 164(f).

For purposes of this subparagraph, section 1402, as in effect for a taxable year ending on December 31, 1962, shall be treated as having been in effect for all taxable years ending before such date.

((B) Repealed)

(C) Income from disposition of certain property

For purposes of this section, the term "earned income" includes gains (other than any gain which is treated under any provision of this chapter as gain from the sale or exchange of a capital asset) and net earnings derived from the sale or other disposition of, the transfer of any interest in, or the licensing of the use of property (other than good will) by an individual whose personal efforts created such property.

(3) Owner-employee

The term "owner-employee" means an employee who -

(A) owns the entire interest in an unincorporated trade or business, or

(B) in the case of a partnership, is a partner who owns more than 10 percent of either the capital interest or the profits interest in such partnership.

To the extent provided in regulations prescribed by the Secretary, such term also means an individual who has been an owner-employee within the meaning of the preceding sentence.

(4) Employer

An individual who owns the entire interest in an unincorporated trade or business shall be treated as his own employer. A partnership shall be treated as the employer of

each partner who is an employee within the meaning of paragraph (1).

(5) Contributions on behalf of owner-employees

The term "contribution on behalf of an owner-employee" includes, except as the context otherwise requires, a contribution under a plan -

(A) by the employer for an owner-employee, and

(B) by an owner-employee as an employee.

(6) Special rule for certain fishermen

For purposes of this subsection, the term "self-employed individual" includes an individual described in section 3121(b)(20) (relating to certain fishermen).

(d) Additional requirements for qualification of trusts and plans benefiting owner-employees

A trust forming part of a pension or profit-sharing plan which provides contributions or benefits for employees some or all of whom are owner-employees shall constitute a qualified trust under this section only if, in addition to meeting the requirements of subsection (a), the following requirements of this subsection are met by the trust and by the plan of which such trust is a part:

(1)(A) If the plan provides contributions or benefits for an owner-employee who controls, or for two or more owner-employees who together control, the trade or business with respect to which the plan is established, and who also control as an owner-employee or as owner-employees one or more other trades or businesses, such plan and the plans established with respect to such other trades or businesses, when coalesced, constitute a single plan which meets the requirements of subsection (a)

(including paragraph (10) thereof) and of this subsection with respect to the employees of all such trades or businesses

(including the trade or business with respect to which the plan intended to qualify under this section is established).

(B) For purposes of subparagraph (A), an owner-employee, or two or more owner-employees, shall be

considered to control a trade or business if such owner-employee, or such two or more owner-employees together -

(i) own the entire interest in an unincorporated trade or business, or

(ii) in the case of a partnership, own more than 50 percent of either the capital interest or the profits interest in such partnership.

For purposes of the preceding sentence, an owner-employee, or two or more owner-employees, shall be treated as owning any interest in a partnership which is owned, directly or indirectly, by a partnership which such owner-employee, or such two or more owner-employees, are considered to control within the meaning of the preceding sentence.

(2) The plan does not provide contributions or benefits for any owner-employee who controls (within the meaning of paragraph

(1)(B)), or for two or more owner-employees who together control, as an owner-employee or as owner-employees, any other trade or business, unless the employees of each trade or business which such owner-employee or such owner-employees control are included under a plan which meets the requirements of subsection (a)

(including paragraph (10) thereof) and of this subsection, and provides contributions and benefits for employees which are not less favorable than contributions and benefits provided for owner-employees under the plan.

(3) Under the plan, contributions on behalf of any owner-employee may be made only with respect to the earned income of such owner-employee which is derived from the trade or business with respect to which such plan is established.

((e) Repealed. Pub. L. 98-369, div. A, title VII, Sec. 713(d)(3), July 18, 1984, 98 Stat. 958)

(f) Certain custodial accounts and contracts

For purposes of this title, a custodial account, an annuity

contract, or a contract (other than a life, health or accident, property, casualty, or liability insurance contract) issued by an insurance company qualified to do business in a State shall be treated as a qualified trust under this section if -

(1) the custodial account or contract would, except for the fact that it is not a trust, constitute a qualified trust under this section, and

(2) in the case of a custodial account the assets thereof are held by a bank (as defined in section 408(n)) or another person who demonstrates, to the satisfaction of the Secretary, that the manner in which he will hold the assets will be consistent with the requirements of this section.

For purposes of this title, in the case of a custodial account or contract treated as a qualified trust under this section by reason of this subsection, the person holding the assets of such account or holding such contract shall be treated as the trustee thereof.

(g) Annuity defined

For purposes of this section and sections 402, 403, and 404, the term "annuity" includes a face-amount certificate, as defined in section 2(a)(15) of the Investment Company Act of 1940 (15 U.S.C., sec. 80a-2), but does not include any contract or certificate issued after December 31, 1962, which is transferable, if any person other than the trustee of a trust described in section 401(a) which is exempt from tax under section 501(a) is the owner of such contract or certificate.

(h) Medical, etc., benefits for retired employees and their spouses and dependents

Under regulations prescribed by the Secretary, and subject to the provisions of section 420, a pension or annuity plan may provide for the payment of benefits for sickness, accident, hospitalization, and medical expenses of retired employees, their spouses and their dependents, but only if -

(1) such benefits are subordinate to the retirement benefits provided by the plan,

(2) a separate account is established and maintained for

such benefits,

(3) the employer's contributions to such separate account are reasonable and ascertainable,

(4) it is impossible, at any time prior to the satisfaction of all liabilities under the plan to provide such benefits, for any part of the corpus or income of such separate account to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than the providing of such benefits,

(5) notwithstanding the provisions of subsection (a)(2), upon the satisfaction of all liabilities under the plan to provide such benefits, any amount remaining in such separate account must, under the terms of the plan, be returned to the employer, and

(6) in the case of an employee who is a key employee, a separate account is established and maintained for such benefits payable to such employee (and his spouse and dependents) and such benefits (to the extent attributable to plan years beginning after March 31, 1984, for which the employee is a key employee) are only payable to such employee (and his spouse and dependents) from such separate account.

For purposes of paragraph (6), the term "key employee" means any employee, who at any time during the plan year or any preceding plan year during which contributions were made on behalf of such employee, is or was a key employee as defined in section 416(i). In no event shall the requirements of paragraph (1) be treated as met if the aggregate actual contributions for medical benefits, when added to actual contributions for life insurance protection under the plan, exceed 25 percent of the total actual contributions to the plan (other than contributions to fund past service credits) after the date on which the account is established.

(i) Certain union-negotiated pension plans

In the case of a trust forming part of a pension plan which has been determined by the Secretary to constitute a qualified

trust under subsection (a) and to be exempt from taxation under section 501(a) for a period beginning after contributions were first made to or for such trust, if it is shown to the satisfaction of the Secretary that -

(1) such trust was created pursuant to a collective bargaining agreement between employee representatives and one or more employers,

(2) any disbursements of contributions, made to or for such trust before the time as of which the Secretary or his delegate determined that the trust constituted a qualified trust, substantially complied with the terms of the trust, and the plan of which the trust is a part, as subsequently qualified, and

(3) before the time as of which the Secretary determined that the trust constitutes a qualified trust, the contributions to or for such trust were not used in a manner which would jeopardize the interests of its beneficiaries, then such trust shall be considered as having constituted a qualified trust under subsection (a) and as having been exempt from taxation under section 501(a) for the period beginning on the date on which contributions were first made to or for such trust and ending on the date such trust first constituted (without regard to this subsection) a qualified trust under subsection (a).

((j) Repealed. Pub. L. 97-248, title II, Sec. 238(b), Sept. 3, 1982, 96 Stat. 512)

(k) Cash or deferred arrangements

(1) General rule

A profit-sharing or stock bonus plan, a pre-ERISA money purchase plan, or a rural cooperative plan shall not be considered as not satisfying the requirements of subsection (a) merely because the plan includes a qualified cash or deferred arrangement.

(2) Qualified cash or deferred arrangement

A qualified cash or deferred arrangement is any arrangement which is part of a profit-sharing or stock bonus

plan, a pre-ERISA money purchase plan, or a rural cooperative plan which meets the requirements of subsection (a) -

(A) under which a covered employee may elect to have the employer make payments as contributions to a trust under the plan on behalf of the employee, or to the employee directly in cash;

(B) under which amounts held by the trust which are attributable to employer contributions made pursuant to the employee's election -

(i) may not be distributable to participants or other beneficiaries earlier than -

(I) separation from service, death, or disability,

(II) an event described in paragraph (10),

(III) in the case of a profit-sharing or stock bonus plan, the attainment of age 59 1/2, or

(IV) in the case of contributions to a profit-sharing or stock bonus plan to which section 402(e)(3) applies, upon hardship of the employee, and

(ii) will not be distributable merely by reason of the completion of a stated period of participation or the lapse of a fixed number of years,

(C) which provides that an employee's right to his accrued benefit derived from employer contributions made to the trust pursuant to his election is nonforfeitable, and

(D) which does not require, as a condition of participation in the arrangement, that an employee complete a period of service with the employer (or employers) maintaining the plan extending beyond the period permitted under section 410(a)(1) (determined without regard to subparagraph (B)(i) thereof).

(3) Application of participation and discrimination standards

(A) A cash or deferred arrangement shall not be treated as a qualified cash or deferred arrangement unless -

(i) those employees eligible to benefit under the

arrangement satisfy the provisions of section 410(b)(1), and

(ii) the actual deferral percentage for eligible highly compensated employees (as defined in paragraph (5)) for such year bears a relationship to the actual deferral percentage for all other eligible employees for such plan year which meets either of the following tests:

(I) The actual deferral percentage for the group of eligible highly compensated employees is not more than the actual deferral percentage of all other eligible employees multiplied by 1.25.

(II) The excess of the actual deferral percentage for the group of eligible highly compensated employees over that of all other eligible employees is not more than 2 percentage points, and the actual deferral percentage for the group of eligible highly compensated employees is not more than the actual deferral percentage of all other eligible employees multiplied by 2.

If 2 or more plans which include cash or deferred arrangements are considered as 1 plan for purposes of section 401(a)(4) or 410(b), the cash or deferred arrangements included in such plans shall be treated as 1 arrangement for purposes of this subparagraph.

If any highly compensated employee is a participant under 2 or more cash or deferred arrangements of the employer, for purposes of determining the deferral percentage with respect to such employee, all such cash or deferred arrangements shall be treated as 1 cash or deferred arrangement.

(B) For purposes of subparagraph (A), the actual deferral percentage for a specified group of employees for a plan year shall be the average of the ratios (calculated separately for each employee in such group) of -

(i) the amount of employer contributions actually paid over to the trust on behalf of each such employee for such plan year, to

(ii) the employee's compensation for such plan year.

(C) A cash or deferred arrangement shall be treated as meeting the requirements of subsection (a)(4) with respect to contributions if the requirements of subparagraph (A)(ii) are met.

(D) For purposes of subparagraph (B), the employer contributions on behalf of any employee -

(i) shall include any employer contributions made pursuant to the employee's election under paragraph (2), and

(ii) under such rules as the Secretary may prescribe, may, at the election of the employer, include -

(I) matching contributions (as defined in 401(m)(4)(A)) which meet the requirements of paragraph (2)(B) and (C), and

(II) qualified nonelective contributions (within the meaning of section 401(m)(4)(C)).

(4) Other requirements

(A) Benefits (other than matching contributions) must not be contingent on election to defer

A cash or deferred arrangement of any employer shall not be treated as a qualified cash or deferred arrangement if any other benefit is conditioned (directly or indirectly) on the employee electing to have the employer make or not make contributions under the arrangement in lieu of receiving cash.

The preceding sentence shall not apply to any matching contribution (as defined in section 401(m)) made by reason of such an election.

(B) State and local governments and tax-exempt organizations not eligible

A cash or deferred arrangement shall not be treated as a qualified cash or deferred arrangement if it is part of a plan maintained by -

(i) a State or local government or political subdivision thereof, or any agency or instrumentality thereof, or

(ii) any organization exempt from tax under this subtitle.

This subparagraph shall not apply to a rural cooperative plan.

(C) Coordination with other plans

Except as provided in section 401(m), any employer contribution made pursuant to an employee's election under a qualified cash or deferred arrangement shall not be taken into account for purposes of determining whether any other plan meets the requirements of section 401(a) or 410(b). This subparagraph shall not apply for purposes of determining whether a plan meets the average benefit requirement of section 410(b)(2)(A)(ii).

(5) Highly compensated employee

For purposes of this subsection, the term "highly compensated employee" has the meaning given such term by section 414(q).

(6) Pre-ERISA money purchase plan

For purposes of this subsection, the term "pre-ERISA money purchase plan" means a pension plan -

(A) which is a defined contribution plan (as defined in section 414(i)),

(B) which was in existence on June 27, 1974, and which, on such date, included a salary reduction arrangement, and

(C) under which neither the employee contributions nor the employer contributions may exceed the levels provided for by the contribution formula in effect under the plan on such date.

(7) Rural cooperative plan

For purposes of this subsection -

(A) In general

The term "rural cooperative plan" means any pension plan -

(i) which is a defined contribution plan (as defined in section 414(i)), and

(ii) which is established and maintained by a rural cooperative.

(B) Rural cooperative defined

For purposes of subparagraph (A), the term "rural cooperative" means -

(i) any organization which -

(I) is exempt from tax under this subtitle or which is a State or local government or political subdivision thereof (or agency or instrumentality thereof), and

(II) is engaged primarily in providing electric service on a mutual or cooperative basis,

(ii) any organization described in paragraph (4) or (6) of section 501(c) and at least 80 percent of the members of which are organizations described in clause (i),

(iii) a cooperative telephone company described in section 501(c)(12), and

(iv) an organization which is a national association of organizations described in clause (i), (ii), or (iii).

(8) Arrangement not disqualified if excess contributions distributed

(A) In general

A cash or deferred arrangement shall not be treated as failing to meet the requirements of clause (ii) of paragraph

(3)(A) for any plan year if, before the close of the following plan year -

(i) the amount of the excess contributions for such plan year (and any income allocable to such contributions) is distributed, or

(ii) to the extent provided in regulations, the employee elects to treat the amount of the excess contributions as an amount distributed to the employee and then contributed by the employee to the plan.

Any distribution of excess contributions (and income) may be made without regard to any other provision of law.

(B) Excess contributions

For purposes of subparagraph (A), the term "excess contributions" means, with respect to any plan year, the excess of -

(i) the aggregate amount of employer contributions actually paid over to the trust on behalf of highly compensated employees for such plan year, over

(ii) the maximum amount of such contributions permitted under the limitations of clause (ii) of paragraph (3)(A) (determined by reducing contributions made on behalf of highly compensated employees in order of the actual deferral percentages beginning with the highest of such percentages).

(C) Method of distributing excess contributions

Any distribution of the excess contributions for any plan year shall be made to highly compensated employees on the basis of the respective portions of the excess contributions attributable to each of such employees.

(D) Additional tax under section 72(t) not to apply

No tax shall be imposed under section 72(t) on any amount required to be distributed under this paragraph.

(E) Treatment of matching contributions forfeited by reason of excess deferral or contribution

For purposes of paragraph (2)(C), a matching contribution (within the meaning of subsection (m)) shall not be treated as forfeitable merely because such contribution is forfeitable if the contribution to which the matching contribution relates is treated as an excess contribution under subparagraph (B), an excess deferral under section 402(g)(2)(A), or an excess aggregate contribution under section 401(m)(6)(B).

(F) Cross reference

For excise tax on certain excess contributions, see section 4979.

(9) Compensation

For purposes of this subsection, the term "compensation" has the meaning given such term by section 414(s).

(10) Distributions upon termination of plan or disposition of assets or subsidiary

(A) In general

The following events are described in this paragraph.

(i) Termination

The termination of the plan without establishment or maintenance of another defined contribution plan (other than

an employee stock ownership plan as defined in section 4975(e)(7)).

(ii) Disposition of assets

The disposition by a corporation of substantially all of the assets (within the meaning of section 409(d)(2)) used by such corporation in a trade or business of such corporation, but only with respect to an employee who continues employment with the corporation acquiring such assets.

(iii) Disposition of subsidiary

The disposition by a corporation of such corporation's interest in a subsidiary (within the meaning of section 409(d)(3)), but only with respect to an employee who continues employment with such subsidiary.

(B) Distributions must be lump sum distributions

(i) In general

An event shall not be treated as described in subparagraph

(A) with respect to any employee unless the employee receives a lump sum distribution by reason of the event.

(ii) Lump sum distribution

For purposes of this subparagraph, the term "lump sum distribution" has the meaning given such term by section 402(d)(4), without regard to clauses (i), (ii), (iii), and

(iv) of subparagraph (A), subparagraph (B), or subparagraph

(F) thereof.

(C) Transferor corporation must maintain plan

An event shall not be treated as described in clause (ii) or

(iii) of subparagraph (A) unless the transferor corporation continues to maintain the plan after the disposition.

(l) Permitted disparity in plan contributions or benefits

(1) In general

The requirements of this subsection are met with respect to a plan if -

(A) in the case of a defined contribution plan, the requirements of paragraph (2) are met, and

(B) in the case of a defined benefit plan, the requirements of paragraph (3) are met.

(2) Defined contribution plan

(A) In general

A defined contribution plan meets the requirements of this paragraph if the excess contribution percentage does not exceed the base contribution percentage by more than the lesser of -

(i) the base contribution percentage, or

(ii) the greater of -

(I) 5.7 percentage points, or

(II) the percentage equal to the portion of the rate of tax under section 3111(a) (in effect as of the beginning of the year) which is attributable to old-age insurance.

(B) Contribution percentages

For purposes of this paragraph -

(i) Excess contribution percentage

The term "excess contribution percentage" means the percentage of compensation which is contributed by the employer under the plan with respect to that portion of each participant's compensation in excess of the integration level.

(ii) Base contribution percentage

The term "base contribution percentage" means the percentage of compensation contributed by the employer under the plan with respect to that portion of each participant's compensation not in excess of the integration level.

(3) Defined benefit plan

A defined benefit plan meets the requirements of this paragraph if -

(A) Excess plans

(i) In general

In the case of a plan other than an offset plan -

(I) the excess benefit percentage does not exceed the base benefit percentage by more than the maximum excess allowance,

(II) any optional form of benefit, preretirement benefit, actuarial factor, or other benefit or feature provided with respect to compensation in excess of the integration level is provided with respect to compensation not in excess of such level, and

(III) benefits are based on average annual compensation.

(ii) Benefit percentages

For purposes of this subparagraph, the excess and base benefit percentages shall be computed in the same manner as the excess and base contribution percentages under paragraph (2)(B), except that such determination shall be made on the basis of benefits attributable to employer contributions rather than contributions.

(B) Offset plans

In the case of an offset plan, the plan provides that -

(i) a participant's accrued benefit attributable to employer contributions (within the meaning of section 411(c)(1)) may not be reduced (by reason of the offset) by more than the maximum offset allowance, and

(ii) benefits are based on average annual compensation

(4) Definitions relating to paragraph (3)

For purposes of paragraph (3) -

(A) Maximum excess allowance

The maximum excess allowance is equal to -

(i) in the case of benefits attributable to any year of service with the employer taken into account under the plan, 3/4 of a percentage point, and

(ii) in the case of total benefits, 3/4 of a percentage point, multiplied by the participant's years of service (not in excess of 35) with the employer taken into account under the plan.

In no event shall the maximum excess allowance exceed the base benefit percentage.

(B) Maximum offset allowance

The maximum offset allowance is equal to -

(i) in the case of benefits attributable to any year of service with the employer taken into account under the plan,

3/4 percent of the participant's final average compensation, and

(ii) in the case of total benefits, 3/4 percent of the participant's final average compensation, multiplied by the participant's years of service (not in excess of 35) with the employer taken into account under the plan.

In no event shall the maximum offset allowance exceed 50 percent of the benefit which would have accrued without regard to the offset reduction.

(C) Reductions

(i) In general

The Secretary shall prescribe regulations requiring the reduction of the 3/4 percentage factor under subparagraph (A) or (B) -

(I) in the case of a plan other than an offset plan which has an integration level in excess of covered compensation, or

(II) with respect to any participant in an offset plan who has final average compensation in excess of covered compensation.

(ii) Basis of reductions

Any reductions under clause (i) shall be based on the percentages of compensation replaced by the employer-derived portions of primary insurance amounts under the Social

Security Act for participants with compensation in excess of covered compensation.

(D) Offset plan

The term "offset plan" means any plan with respect to which the benefit attributable to employer contributions for each participant is reduced by an amount specified in the plan.

(5) Other definitions and special rules

For purposes of this subsection -

(A) Integration level

(i) In general

The term "integration level" means the amount of compensation specified under the plan (by dollar amount or formula) at or below which the rate at which contributions or benefits are provided (expressed as a percentage) is less than such rate above such amount.

(ii) Limitation

The integration level for any year may not exceed the contribution and benefit base in effect under section 230 of the Social Security Act for such year.

(iii) Level to apply to all participants

A plan's integration level shall apply with respect to all participants in the plan.

(iv) Multiple integration levels

Under rules prescribed by the Secretary, a defined benefit plan may specify multiple integration levels.

(B) Compensation

The term "compensation" has the meaning given such term by section 414(s).

(C) Average annual compensation

The term "average annual compensation" means the participant's highest average annual compensation for -

(i) any period of at least 3 consecutive years, or

(ii) if shorter, the participant's full period of service.

(D) Final average compensation

(i) In general

The term "final average compensation" means the participant's average annual compensation for -

(I) the 3-consecutive year period ending with the current year, or

(II) if shorter, the participant's full period of service.

(ii) Limitation

A participant's final average compensation shall be determined by not taking into account in any year compensation in excess of the contribution and benefit base in effect under section 230 of the Social Security Act for such year.

(E) Covered compensation

(i) In general

The term "covered compensation" means, with respect to an employee, the average of the contribution and benefit bases in effect under section 230 of the Social Security Act for each year in the 35-year period ending with the year in which the employee attains the social security retirement age.

(ii) Computation for any year

For purposes of clause (i), the determination for any year preceding the year in which the employee attains the social security retirement age shall be made by assuming that there is no increase in the bases described in clause (i) after the determination year and before the employee attains the social security retirement age.

(iii) Social security retirement age

For purposes of this subparagraph, the term "social security retirement age" has the meaning given such term by section 415(b)(8).

(F) Regulations

The Secretary shall prescribe such regulations as are necessary or appropriate to carry out the purposes of this subsection, including -

(i) in the case of a defined benefit plan which provides for unreduced benefits commencing before the social security retirement age (as defined in section 415(b)(8)), rules providing for the reduction of the maximum excess allowance and the maximum offset allowance, and

(ii) in the case of an employee covered by 2 or more plans of the employer which fail to meet the requirements of subsection (a)(4) (without regard to this subsection), rules preventing the multiple use of the disparity permitted under this subsection with respect to any employee.

For purposes of clause (i), unreduced benefits shall not include benefits for disability (within the meaning of section 223(d) of the Social Security Act).

(6) Special rule for plan maintained by railroads

In determining whether a plan which includes employees of a railroad employer who are entitled to benefits under the Railroad

Retirement Act of 1974 meets the requirements of this subsection, rules similar to the rules set forth in this subsection shall apply. Such rules shall take into account the employer-derived portion of the employees' tier 2 railroad retirement benefits and any supplemental annuity under the Railroad Retirement Act of 1974.

(m) Nondiscrimination test for matching contributions and employee contributions

(1) In general

A defined contribution plan shall be treated as meeting the requirements of subsection (a)(4) with respect to the amount of any matching contribution or employee contribution for any plan year only if the contribution percentage requirement of paragraph

(2) of this subsection is met for such plan year.

(2) Requirements

(A) Contribution percentage requirement

A plan meets the contribution percentage requirement of this paragraph for any plan year only if the contribution percentage for eligible highly compensated employees does not exceed the greater of -

(i) 125 percent of such percentage for all other eligible employees, or

(ii) the lesser of 200 percent of such percentage for all other eligible employees, or such percentage for all other eligible employees plus 2 percentage points.

(B) Multiple plans treated as a single plan

If two or more plans of an employer to which matching contributions, employee contributions, or elective deferrals are made are treated as one plan for purposes of section 410(b), such plans shall be treated as one plan for purposes of this subsection. If a highly compensated employee participates in two or more plans of an employer to which

contributions to which this subsection applies are made, all such contributions shall be aggregated for purposes of this subsection.

(3) Contribution percentage

For purposes of paragraph (2), the contribution percentage for a specified group of employees for a plan year shall be the average of the ratios (calculated separately for each employee in such group) of -

(A) the sum of the matching contributions and employee contributions paid under the plan on behalf of each such employee for such plan year, to

(B) the employee's compensation (within the meaning of section 414(s)) for such plan year.

Under regulations, an employer may elect to take into account (in computing the contribution percentage) elective deferrals and qualified nonelective contributions under the plan or any other plan of the employer. If matching contributions are taken into account for purposes of subsection (k)(3)(A)(ii) for any plan year, such contributions shall not be taken into account under subparagraph (A) for such year.

(4) Definitions

For purposes of this subsection -

(A) Matching contribution

The term "matching contribution" means -

(i) any employer contribution made to a defined contribution plan on behalf of an employee on account of an employee contribution made by such employee, and

(ii) any employer contribution made to a defined contribution plan on behalf of an employee on account of an employee's elective deferral.

(B) Elective deferral

The term "elective deferral" means any employer contribution described in section 402(g)(3).

(C) Qualified nonelective contributions

The term "qualified nonelective contribution" means any

employer contribution (other than a matching contribution) with respect to which -

(i) the employee may not elect to have the contribution paid to the employee in cash instead of being contributed to the plan, and

(ii) the requirements of subparagraphs (B) and (C) of subsection (k)(2) are met.

(5) Employees taken into consideration

(A) In general

Any employee who is eligible to make an employee contribution

(or, if the employer takes elective contributions into account, elective contributions) or to receive a matching contribution under the plan being tested under paragraph (1) shall be considered an eligible employee for purposes of this subsection.

(B) Certain nonparticipants

If an employee contribution is required as a condition of participation in the plan, any employee who would be a participant in the plan if such employee made such a contribution shall be treated as an eligible employee on behalf of whom no employer contributions are made.

(6) Plan not disqualified if excess aggregate contributions distributed before end of following plan year

(A) In general

A plan shall not be treated as failing to meet the requirements of paragraph (1) for any plan year if, before the close of the following plan year, the amount of the excess aggregate contributions for such plan year (and any income allocable to such contributions) is distributed (or, if forfeitable, is forfeited). Such contributions (and such income) may be distributed without regard to any other provision of law.

(B) Excess aggregate contributions

For purposes of subparagraph (A), the term "excess aggregate contributions" means, with respect to any plan

year, the excess of -

(i) the aggregate amount of the matching contributions and employee contributions (and any qualified nonelective contribution or elective contribution taken into account in computing the contribution percentage) actually made on behalf of highly compensated employees for such plan year, over

(ii) the maximum amount of such contributions permitted under the limitations of paragraph (2)(A) (determined by reducing contributions made on behalf of highly compensated employees in order of their contribution percentages beginning with the highest of such percentages).

(C) Method of distributing excess aggregate contributions

Any distribution of the excess aggregate contributions for any plan year shall be made to highly compensated employees on the basis of the respective portions of such amounts attributable to each of such employees. Forfeitures of excess aggregate contributions may not be allocated to participants whose contributions are reduced under this paragraph.

(D) Coordination with subsection (k) and 402(g)

The determination of the amount of excess aggregate contributions with respect to a plan shall be made after -

(i) first determining the excess deferrals (within the meaning of section 402(g)), and

(ii) then determining the excess contributions under subsection (k).

(7) Treatment of distributions

(A) Additional tax of section 72(t) not applicable

No tax shall be imposed under section 72(t) on any amount required to be distributed under paragraph (6).

(B) Exclusion of employee contributions

Any distribution attributable to employee contributions shall not be included in gross income except to the extent attributable to income on such contributions.

(8) Highly compensated employee

For purposes of this subsection, the term "highly compensated employee" has the meaning given to such term by section 414(q).

(9) Regulations

The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection and subsection (k) including -

(A) such regulations as may be necessary to prevent the multiple use of the alternative limitation with respect to any highly compensated employee, and

(B) regulations permitting appropriate aggregation of plans and contributions.

For purposes of the preceding sentence, the term "alternative limitation" means the limitation of section 401(k)(3)(A)(ii)(II) and the limitation of paragraph (2)(A)(ii) of this subsection.

(10) Cross reference

For excise tax on certain excess contributions, see section 4979.

(n) Coordination with qualified domestic relations orders

The Secretary shall prescribe such rules or regulations as may be necessary to coordinate the requirements of subsection (a)(13)(B) and section 414(p) (and the regulations issued by the Secretary of Labor thereunder) with the other provisions of this chapter.

(o) Cross reference

For exemption from tax of a trust qualified under this section, see section 501(a).

26 U.S.C. § 402(a). Taxability of beneficiary of employees' trust

(a) Taxability of beneficiary of exempt trust

Except as otherwise provided in this section, any amount actually distributed to any distributee by any employees' trust described in section 401(a) which is exempt from tax under section 501(a) shall be taxable to the distributee, in the taxable year of the distributee in which distributed, under

section 72 (relating to annuities).

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26 U.S.C. § 501 Exemption from tax on corporations, certain trusts, etc.

(a) Exemption from taxation

An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503.

(b) Tax on unrelated business income and certain other activities

An organization exempt from taxation under subsection (a) shall be subject to tax to the extent provided in parts II, III, and VI of this subchapter, but (notwithstanding parts II, III, and VI of this subchapter) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

(c) List of exempt organizations

The following organizations are referred to in subsection (a):

(1) Any corporation organized under Act of Congress which is an instrumentality of the United States but only if such corporation -

(A) is exempt from Federal income taxes -

(i) under such Act as amended and supplemented before July 18, 1984, or

(ii) under this title without regard to any provision of law which is not contained in this title and which is not contained in a revenue Act, or

(B) is described in subsection (l).

(2) Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which

itself is exempt under this section. Rules similar to the rules of subparagraph (G) of paragraph (25) shall apply for purposes of this paragraph.

(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

(4) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes.

(5) Labor, agricultural, or horticultural organizations.

(6) Business leagues, chambers of commerce, real-estate boards, boards of trade, or professional football leagues (whether or not administering a pension fund for football players), not organized for profit and no part of the net earnings of which

inures to the benefit of any private shareholder or individual.

(7) Clubs organized for pleasure, recreation, and other nonprofitable purposes, substantially all of the activities of which are for such purposes and no part of the net earnings of which inures to the benefit of any private shareholder.

(8) Fraternal beneficiary societies, orders, or associations -

(A) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and

(B) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents.

(9) Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries, if no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual.

(10) Domestic fraternal societies, orders, or associations, operating under the lodge system -

(A) the net earnings of which are devoted exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes, and

(B) which do not provide for the payment of life, sick, accident, or other benefits.

(11) Teachers' retirement fund associations of a purely local character, if -

(A) no part of their net earnings inures (other than through payment of retirement benefits) to the benefit of any private shareholder or individual, and

(B) the income consists solely of amounts

received from public taxation, amounts received from assessments on the teaching salaries of members, and income in respect of investments.

(12)

(A) Benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses.

(B) In the case of a mutual or cooperative telephone company, subparagraph (A) shall be applied without taking into account any income received or accrued -

(i) from a nonmember telephone company for the performance of communication services which involve members of the mutual or cooperative telephone company,

(ii) from qualified pole rentals,

(iii) from the sale of display listings in a directory furnished to the members of the mutual or cooperative telephone company, or

(iv) from the prepayment of a loan under section 306A, 306B, or 311 of the Rural Electrification Act of 1936 (as in effect on January 1, 1987).

(C) In the case of a mutual or cooperative electric company, subparagraph (A) shall be applied without taking into account any income received or accrued -

(i) from qualified pole rentals, or

(ii) from the prepayment of a loan under section 306A, 306B, or 311 of the Rural Electrification Act of 1936 (as in effect on January 1, 1987).

(D) For purposes of this paragraph, the term "qualified pole rental" means any rental of a pole

(or other structure used to support wires) if such pole (or other structure) -

(i) is used by the telephone or electric company to support one or more wires which are used by such company in providing telephone or electric services to its members, and

(ii) is used pursuant to the rental to support one or more wires (in addition to the wires described in clause (i)) for use in connection with the transmission by wire of electricity or of telephone or other communications.

For purposes of the preceding sentence, the term "rental" includes any sale of the right to use the pole (or other structure).

(13) Cemetery companies owned and operated exclusively for the benefit of their members or which are not operated for profit; and any corporation chartered solely for the purpose of the disposal of bodies by burial or cremation which is not permitted by its charter to engage in any business not necessarily incident to that purpose and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

(14)

(A) Credit unions without capital stock organized and operated for mutual purposes and without profit.

(B) Corporations or associations without capital stock organized before September 1, 1957, and operated for mutual purposes and without profit for the purpose of providing reserve funds for, and insurance of shares or deposits in -

(i) domestic building and loan associations,

(ii) cooperative banks without capital stock organized and operated for mutual purposes and without profit,

(iii) mutual savings banks not having capital stock represented by shares, or

(iv) mutual savings banks described in section 591(b)

(FOOTNOTE 1)

(FOOTNOTE 1) So in original. Probably should be followed by a period.

(C) Corporations or associations organized before September 1,

1957, and operated for mutual purposes and without profit for the purpose of providing reserve funds for associations or banks described in clause (i), (ii), or (iii) of subparagraph (B); but only if 85 percent or more of the income is attributable to providing such reserve funds and to investments. This subparagraph shall not apply to any corporation or association entitled to exemption under subparagraph (B).

(15)

(A) Insurance companies or associations other than life (including interinsurers and reciprocal underwriters) if the net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed $350,000.

(B) For purposes of subparagraph (A), in determining whether any company or association is described in subparagraph (A), such company or association shall be treated as receiving during the taxable year amounts described in subparagraph (A) which are received during such year by all other companies or associations which are members of the same controlled group as the insurance company or association for which the determination is being made.

(C) For purposes of subparagraph (B), the term "controlled group" has the meaning given such term by section 831(b)(2)(B)(ii).

(16) Corporations organized by an association subject to part IV of this subchapter or members thereof, for the purpose of financing the ordinary crop operations of such members or other producers, and operated in conjunction with such association.

Exemption shall not be denied any such corporation because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the corporation, on dissolution or otherwise, beyond the fixed dividends) is owned by such association, or members thereof; nor shall exemption be denied any such corporation because there is accumulated and maintained by it a reserve required by State law or a reasonable reserve for any necessary purpose.

(17)

(A) A trust or trusts forming part of a plan providing for the payment of supplemental unemployment compensation benefits, if -

(i) under the plan, it is impossible, at any time prior to the satisfaction of all liabilities, with respect to employees under the plan, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than the providing of supplemental unemployment compensation benefits,

(ii) such benefits are payable to employees under a classification which is set forth in the plan and which is found by the Secretary not to be discriminatory in favor of employees who are highly compensated employees (within the meaning of section 414(q)), and

(iii) such benefits do not discriminate in favor of employees who are highly compensated employees (within the meaning of section 414(q)). A plan shall not be considered discriminatory within the meaning of this clause merely because the benefits received under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of the employees covered by the plan.

(B) In determining whether a plan meets the requirements of subparagraph (A), any benefits provided under any other plan shall not be taken into consideration, except that a plan shall not be considered discriminatory -

(i) merely because the benefits under the plan which are first determined in a nondiscriminatory manner within the meaning of subparagraph (A) are then reduced by any sick, accident, or unemployment compensation benefits received under State or Federal law (or reduced by a portion of such benefits if determined in a nondiscriminatory manner), or

(ii) merely because the plan provides only for employees who are not eligible to receive sick, accident, or unemployment compensation benefits under State or Federal law the same benefits (or a portion of such benefits if determined in a nondiscriminatory manner) which such employees would receive under such laws if such employees were eligible for such benefits, or

(iii) merely because the plan provides only for employees who are not eligible under another plan (which meets the requirements of subparagraph (A)) of supplemental unemployment compensation benefits provided

wholly by the employer the same benefits (or a portion of such benefits if determined in a nondiscriminatory manner) which such employees would receive under such other plan if such employees were eligible under such other plan, but only if the employees eligible under both plans would make a classification which would be nondiscriminatory within the meaning of subparagraph (A).

(C) A plan shall be considered to meet the requirements of subparagraph (A) during the whole of any year of the plan if on one day in each quarter it satisfies such requirements.

(D) The term "supplemental unemployment compensation benefits" means only -

(i) benefits which are paid to an employee because of his involuntary separation from the employment of the employer (whether or not such separation is temporary) resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions, and

(ii) sick and accident benefits subordinate to the benefits described in clause (i).

(E) Exemption shall not be denied under subsection (a) to any organization entitled to such exemption as an association described in paragraph (9) of this subsection merely because such organization provides for the payment of supplemental unemployment benefits (as defined in subparagraph (D)(i)).

(18) A trust or trusts created before June 25, 1959, forming part of a plan providing for the payment of benefits under a pension plan funded only by contributions of employees, if -

(A) under the plan, it is impossible, at any time prior to the satisfaction of all liabilities with

respect to employees under the plan, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than the providing of benefits under the plan,

(B) such benefits are payable to employees under a classification which is set forth in the plan and which is found by the Secretary not to be discriminatory in favor of employees who are highly compensated employees (within the meaning of section 414(q)),

(C) such benefits do not discriminate in favor of employees who are highly compensated employees (within the meaning of section 414(q)). A plan shall not be considered discriminatory within the meaning of this subparagraph merely because the benefits received under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of the employees covered by the plan, and

(D) in the case of a plan under which an employee may designate certain contributions as deductible -

(i) such contributions do not exceed the amount with respect to which a deduction is allowable under section 219(b)(3),

(ii) requirements similar to the requirements of section 401(k)(3)(A)(ii) are met with respect to such elective contributions,

(iii) such contributions are treated as elective deferrals for purposes of section 402(g) (other than paragraph (4) thereof), and

(iv) the requirements of section 401(a)(30) are met.

For purposes of subparagraph (D)(ii), rules similar to the

rules of section 401(k)(8) shall apply. For purposes of section 4979, any excess contribution under clause (ii) shall be treated as an excess contribution under a cash or deferred arrangement.

(19) A post or organization of past or present members of the Armed Forces of the United States, or an auxiliary unit or society of, or a trust or foundation for, any such post or organization -

(A) organized in the United States or any of its possessions,

(B) at least 75 percent of the members of which are past or present members of the Armed Forces of the United States and substantially all of the other members of which are individuals who are cadets or are spouses, widows, or widowers of past or present members of the Armed Forces of the United States or of cadets, and

(C) no part of the net earnings of which inures to the benefit of any private shareholder or individual.

(20) an (FOOTNOTE 2) organization or trust created or organized in the United States, the exclusive function of which is to form part of a qualified group legal services plan or plans, within the meaning of section 120. An organization or trust which receives contributions because of section 120(c)(5)(C) shall not be prevented from qualifying as an organization described in this paragraph merely because it provides legal services or indemnification against the cost of legal services unassociated with a qualified group legal services plan.

(FOOTNOTE 2) So in original. Probably should be capitalized.

(21)

(A) A trust or trusts established in writing, created

or organized in the United States, and contributed to by any person (except an insurance company) if -

(i) the purpose of such trust or trusts is exclusively -

(I) to satisfy, in whole or in part, the liability of such person for, or with respect to, claims for compensation for disability or death due to pneumoconiosis under Black Lung Acts,

(II) to pay premiums for insurance exclusively covering such liability,

(III) to pay administrative and other incidental expenses of such trust in connection with the operation of the trust and the processing of claims against such person under Black Lung Acts, and

(IV) to pay accident or health benefits for retired miners and their spouses and dependents (including administrative and other incidental expenses of such trust in connection therewith) or premiums for insurance exclusively covering such benefits; and

(ii) no part of the assets of the trust may be used for, or diverted to, any purpose other than -

(I) the purposes described in clause (i),

(II) investment (but only to the extent that the trustee determines that a portion of the assets is not currently needed for the purposes described in clause (i)) in qualified investments, or

(III) payment into the Black Lung Disability Trust Fund established under section 9501, or into the

general fund of the United States Treasury (other than in satisfaction of any tax or other civil or criminal liability of the person who established or contributed to the trust).

(B) No deduction shall be allowed under this chapter for any payment described in subparagraph (A)(i)(IV) from such trust.

(C) Payments described in subparagraph (A)(i)(IV) may be made from such trust during a taxable year only to the extent that the aggregate amount of such payments during such taxable year does not exceed the lesser of -

(i) the excess (if any) (as of the close of the preceding taxable year) of -

(I) the fair market value of the assets of the trust, over

(II) 110 percent of the present value of the liability described in subparagraph (A)(i)(I) of such person, or

(ii) the excess (if any) of -

(I) the sum of a similar excess determined as of the close of the last taxable year ending before the date of the enactment of this subparagraph plus earnings thereon as of the close of the taxable year preceding the taxable year involved, over

(II) the aggregate payments described in subparagraph (A)(i)(IV) made from the trust during all taxable years beginning after the date of the enactment of this subparagraph.

The determinations under the preceding sentence shall be made by an independent actuary using actuarial methods and assumptions (not inconsistent with the

regulations prescribed under section 192(c)(1)(A)) each of which is reasonable and which are reasonable in the aggregate.

(D) For purposes of this paragraph:

(i) The term "Black Lung Acts" means part C of title IV of the Federal Mine Safety and Health Act of 1977, and any State law providing compensation for disability or death due to that pneumoconiosis.

(ii) The term "qualified investments" means -

(I) public debt securities of the United States,

(II) obligations of a State or local government which are not in default as to principal or interest, and

(III) time or demand deposits in a bank (as defined in section 581) or an insured credit union (within the meaning of section 101(6) (FOOTNOTE 3) of the Federal Credit Union Act, 12 U.S.C. 1752(6)) (FOOTNOTE 3) located in the United States.

(FOOTNOTE 3) So in original. References to "101(6)" and "1752(6)" probably should be to "101(7)" and "1752(7)", respectively.

(iii) The term "miner" has the same meaning as such term has when used in section 402(d) of the Black Lung Benefits Act (30 U.S.C. 902(d)).

(iv) The term "incidental expenses" includes legal, accounting, actuarial, and trustee expenses.

(22) A trust created or organized in the United States and established in writing by the plan sponsors of multiemployer plans if -

(A) the purpose of such trust is exclusively -

(i) to pay any amount described in section 4223(c) or (h) of the Employee Retirement

Income Security Act of 1974, and

(ii) to pay reasonable and necessary administrative expenses in connection with the establishment and operation of the trust and the processing of claims against the trust,

(B) no part of the assets of the trust may be used for, or diverted to, any purpose other than -

(i) the purposes described in subparagraph (A), or

(ii) the investment in securities, obligations, or time or demand deposits described in clause (ii) of paragraph (21)(B),

(C) such trust meets the requirements of paragraphs (2), (3), and (4) of section 4223(b), 4223(h), or, if applicable, section 4223(c) of the Employee Retirement Income Security Act of 1974, and

(D) the trust instrument provides that, on dissolution of the trust, assets of the trust may not be paid other than to plans which have participated in the plan or, in the case of a trust established under section 4223(h) of such Act, to plans with respect to which employers have participated in the fund.

(23) Any association organized before 1880 more than 75 percent of the members of which are present or past members of the Armed Forces and a principal purpose of which is to provide insurance and other benefits to veterans or their dependents.

(24) A trust described in section 4049 of the Employee Retirement Income Security Act of 1974 (as in effect on the date of the enactment of the Single-Employer Pension Plan Amendments Act of 1986).

(25)

(A) Any corporation or trust which -

(i) has no more than 35 shareholders or

beneficiaries,

(ii) has only 1 class of stock or beneficial interest, and

(iii) is organized for the exclusive purposes of -

(I) acquiring real property and holding title to, and collecting income from, such property, and

(II) remitting the entire amount of income from such property (less expenses) to 1 or more organizations described in subparagraph (C) which are shareholders of such corporation or beneficiaries of such trust. For purposes of clause (iii), the term "real property" shall not include any interest as a tenant in common (or similar interest) and shall not include any indirect interest.

(B) A corporation or trust shall be described in subparagraph (A) without regard to whether the corporation or trust is organized by 1 or more organizations described in subparagraph (C).

(C) An organization is described in this subparagraph if such organization is -

(i) a qualified pension, profit sharing, or stock bonus plan that meets the requirements of section 401(a),

(ii) a governmental plan (within the meaning of section 414(d)),

(iii) the United States, any State or political subdivision thereof, or any agency or instrumentality of any of the foregoing, or

(iv) any organization described in paragraph (3).

(D) A corporation or trust shall in no event be treated as described in subparagraph (A) unless such corporation or trust permits its shareholders or beneficiaries -

(i) to dismiss the corporation's or trust's investment adviser, following reasonable notice, upon a vote of the shareholders or beneficiaries holding a majority of interest in the corporation or trust, and

(ii) to terminate their interest in the corporation or trust by either, or both, of the following alternatives, as determined by the corporation or trust:

(I) by selling or exchanging their stock in the corporation or interest in the trust (subject to any Federal or State securities law) to any organization described in subparagraph (C) so long as the sale or exchange does not increase the number of shareholders or beneficiaries in such corporation or trust above 35, or

(II) by having their stock or interest redeemed by the corporation or trust after the shareholder or beneficiary has provided 90 days notice to such corporation or trust.

(E)

(i) For purposes of this title -

(I) a corporation which is a qualified subsidiary shall not be treated as a separate corporation, and

(II) all assets, liabilities, and items of income, deduction, and credit of a qualified subsidiary shall be treated as assets, liabilities, and such items (as the case may be) of the corporation or trust described in subparagraph (A).

(ii) For purposes of this subparagraph, the term "qualified subsidiary" means any corporation if, at all times during the period such corporation was

in existence, 100 percent of the stock of such corporation is held by the corporation or trust described in subparagraph (A).

(iii) For purposes of this subtitle, if any corporation which was a qualified subsidiary ceases to meet the requirements of clause (ii), such corporation shall be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before such cessation from the corporation or trust described in subparagraph (A) in exchange for its stock.

(F) For purposes of subparagraph (A), the term "real property" includes any personal property which is leased under, or in connection with, a lease of real property, but only if the rent attributable to such personal property (determined under the rules of section 856(d)(1)) for the taxable year does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, such lease.

(G)

(i) An organization shall not be treated as failing to be described in this paragraph merely by reason of the receipt of any otherwise disqualifying income which is incidentally derived from the holding of real property.

(ii) Clause (i) shall not apply if the amount of gross income described in such clause exceeds 10 percent of the organization's gross income for the taxable year unless the organization establishes to the satisfaction of the Secretary that the receipt of gross income described in clause (i) in excess of such limitation was inadvertent and reasonable steps are being taken to correct the circumstances

giving rise to such income.

(d) Religious and apostolic organizations

The following organizations are referred to in subsection (a): Religious or apostolic associations or corporations, if such associations or corporations have a common treasury or community treasury, even if such associations or corporations engage in business for the common benefit of the members, but only if the members thereof include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the taxable income of the association or corporation for such year. Any amount so included in the gross income of a member shall be treated as a dividend received.

(e) Cooperative hospital service organizations

For purposes of this title, an organization shall be treated as an organization organized and operated exclusively for charitable purposes, if -

(1) such organization is organized and operated solely -

(A) to perform, on a centralized basis, one or more of the following services which, if performed on its own behalf by a hospital which is an organization described in subsection (c)(3) and exempt from taxation under subsection (a), would constitute activities in exercising or performing the purpose or function constituting the basis for its exemption: data processing, purchasing (including the purchasing of insurance on a group basis), warehousing, billing and collection, food, clinical, industrial engineering, laboratory, printing, communications, record center, and personnel (including selection, testing, training, and education of personnel) services; and

(B) to perform such services solely for two or more hospitals each of which is -

(i) an organization described in subsection (c)(3)

which is exempt from taxation under subsection (a),

(ii) a constituent part of an organization described in subsection (c)(3) which is exempt from taxation under subsection (a) and which, if organized and operated as a separate entity, would constitute an organization described in subsection (c)(3), or

(iii) owned and operated by the United States, a State, the District of Columbia, or a possession of the United States, or a political subdivision or an agency or instrumentality of any of the foregoing;

(2) such organization is organized and operated on a cooperative basis and allocates or pays, within 8 1/2 months after the close of its taxable year, all net earnings to patrons on the basis of services performed for them; and

(3) if such organization has capital stock, all of such stock outstanding is owned by its patrons. For purposes of this title, any organization which, by reason of the preceding sentence, is an organization described in subsection (c)(3) and exempt from taxation under subsection (a), shall be treated as a hospital and as an organization referred to in section 170(b)(1)(A)(iii).

(f) Cooperative service organizations of operating educational organizations

For purposes of this title, if an organization is -

(1) organized and operated solely to hold, commingle, and collectively invest and reinvest (including arranging for and supervising the performance by independent contractors of investment services related thereto) in stocks and securities, the moneys contributed thereto by each of the members of such organization, and to collect income therefrom and turn over the entire amount

thereof, less expenses, to such members,

(2) organized and controlled by one or more such members, and

(3) comprised solely of members that are organizations described in clause (ii) or (iv) of section 170(b)(1)(A) -

(A) which are exempt from taxation under subsection (a), or

(B) the income of which is excluded from taxation under section 115(a), then such organization shall be treated as an organization organized and operated exclusively for charitable purposes.

(g) Definition of agricultural

For purposes of subsection (c)(5), the term "agricultural" includes the art or science of cultivating land, harvesting crops or aquatic resources, or raising livestock.

(h) Expenditures by public charities to influence legislation

(1) General rule In the case of an organization to which this subsection applies, exemption from taxation under subsection (a) shall be denied because a substantial part of the activities of such organization consists of carrying on propaganda, or otherwise attempting, to influence legislation, but only if such organization normally -

(A) makes lobbying expenditures in excess of the lobbying ceiling amount for such organization for each taxable year, or

(B) makes grass roots expenditures in excess of the grass roots ceiling amount for such organization for each taxable year.

(2) Definitions For purposes of this subsection -

(A) Lobbying expenditures The term "lobbying expenditures" means expenditures for the purpose of influencing legislation (as defined in section 4911(d)).

(B) Lobbying ceiling amount The lobbying ceiling amount for any organization for any taxable year is 150 percent of the lobbying nontaxable amount for such organization for such taxable year, determined under section 4911.

(C) Grass roots expenditures The term "grass roots expenditures" means expenditures for the purpose of influencing legislation (as defined in section 4911(d) without regard to paragraph (1)(B) thereof).

(D) Grass roots ceiling amount The grass roots ceiling amount for any organization for any taxable year is 150 percent of the grass roots nontaxable amount for such organization for such taxable year, determined under section 4911.

(3) Organizations to which this subsection applies This subsection shall apply to any organization which has elected (in such manner and at such time as the Secretary may prescribe) to have the provisions of this subsection apply to such organization and which, for the taxable year which includes the date the election is made, is described in subsection (c)(3) and -

(A) is described in paragraph (4), and

(B) is not a disqualified organization under paragraph (5).

(4) Organizations permitted to elect to have this subsection apply An organization is described in this paragraph if it is described in -

(A) section 170(b)(1)(A)(ii) (relating to educational institutions),

(B) section 170(b)(1)(A)(iii) (relating to hospitals and medical research organizations),

(C) section 170(b)(1)(A)(iv) (relating to organizations supporting government schools),

(D) section 170(b)(1)(A)(vi) (relating to

organizations publicly supported by charitable contributions),

(E) section 509(a)(2) (relating to organizations publicly supported by admissions, sales, etc.), or

(F) section 509(a)(3) (relating to organizations supporting certain types of public charities) except that for purposes of this subparagraph, section 509(a)(3) shall be applied without regard to the last sentence of section 509(a).

(5) Disqualified organizations For purposes of paragraph (3) an organization is a disqualified organization if it is -

(A) described in section 170(b)(1)(A)(i) (relating to churches),

(B) an integrated auxiliary of a church or of a convention or association of churches, or

(C) a member of an affiliated group of organizations (within the meaning of section 4911(f)(2)) if one or more members of such group is described in subparagraph (A) or (B).

(6) Years for which election is effective An election by an organization under this subsection shall be effective for all taxable years of such organization which -

(A) end after the date the election is made, and

(B) begin before the date the election is revoked by such organization (under regulations prescribed by the Secretary).

(7) No effect on certain organizations With respect to any organization for a taxable year for which -

(A) such organization is a disqualified organization (within the meaning of paragraph (5)), or

(B) an election under this subsection is not in effect for such organization, nothing in this subsection or in section 4911 shall be construed to

affect the interpretation of the phrase, "no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation," under subsection (c)(3).

(8) Affiliated organizations For rules regarding affiliated organizations, see section 4911(f).

(i) Prohibition of discrimination by certain social clubs

Notwithstanding subsection (a), an organization which is described in subsection (c)(7) shall not be exempt from taxation under subsection (a) for any taxable year if, at any time during such taxable year, the charter, bylaws, or other governing instrument, of such organization or any written policy statement of such organization contains a provision which provides for discrimination against any person on the basis of race, color, or religion. The preceding sentence to the extent it relates to discrimination on the basis of religion shall not apply to -

(1) an auxiliary of a fraternal beneficiary society if such society -

(A) is described in subsection (c)(8) and exempt from tax under subsection (a), and

(B) limits its membership to the members of a particular religion, or

(2) a club which in good faith limits its membership to the members of a particular religion in order to further the teachings or principles of that religion, and not to exclude individuals of a particular race or color.

(j) Special rules for certain amateur sports organizations

(1) In general In the case of a qualified amateur sports organization -

(A) the requirement of subsection (c)(3) that no part of its activities involve the provision of athletic facilities or equipment shall not apply, and

(B) such organization shall not fail to meet the

requirements

26 U.S.C. § 1001. Determination of amount of and recognition of gain or loss

(a) Computation of gain or loss

The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) Amount realized

The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized -

(1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and

(2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

(c) Recognition of gain or loss

Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

(d) Installment sales

Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

(e) Certain term interests

(1) In general

In determining gain or loss from the sale or other

disposition of a term interest in property, that portion of the adjusted basis[3] of such interest which is determined pursuant to section 1014[4], 1015[5], or 1041[6] (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded.

(2) Term interest in property defined

For purposes of paragraph (1), the term "term interest in property" means -

(A) a life interest in property,

(B) an interest in property for a term of years, or

(C) an income interest in a trust.

(3) Exception

Paragraph (1) shall not apply to a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to any person or persons.

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26 U.S.C. § 1221. Capital asset defined

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include -

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

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[3] §1011. Adjusted basis for determining gain or loss, §1012. Basis of property - cost.

[4] §1014. Basis of property acquired from a decedent.

[5] §1015. Basis of property acquired by gifts and transfers in trust.

[6] §1041. Transfers of property between spouses or incident to divorce

(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by -

(A) a taxpayer whose personal efforts created such property,

(B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1);

(5) a publication of the United States Government (including the Congressional Record) which is received from the United States Government or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by -

(A) a taxpayer who so received such publication, or

(B) a taxpayer in whose hands the basis of such publication is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such publication in the hands of a taxpayer described in subparagraph (A).

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26 U.S.C. § 1231. Property used in the trade or business and involuntary conversions

(a) General rule

(1) Gains exceed losses

If -

(A) the section 1231 gains for any taxable year, exceed

(B) the section 1231 losses for such taxable year, such gains and losses shall be treated as long-term capital gains or long-term capital losses, as the case may be.

(2) Gains do not exceed losses

If -

(A) the section 1231 gains for any taxable year, do not exceed

(B) the section 1231 losses for such taxable year, such gains and losses shall not be treated as gains and losses from sales or exchanges of capital assets.

(3) Section 1231 gains and losses

For purposes of this subsection -

(A) Section 1231 gain

The term "section 1231 gain" means -

(i) any recognized gain on the sale or exchange of property used in the trade or business, and

(ii) any recognized gain from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) into other property or money of -

(I) property used in the trade or business, or

(II) any capital asset which is held for more than 1 year and is held in connection with a trade or business or a transaction entered into for profit.

(B) Section 1231 loss

The term "section 1231 loss" means any recognized loss from a sale or exchange or conversion described in subparagraph (A).

(4) Special rules

For purposes of this subsection -

(A) In determining under this subsection whether gains exceed losses -

(i) the section 1231 gains shall be included only if and to the extent taken into account in computing gross income, and

(ii) the section 1231 losses shall be included only if and to the extent taken into account in computing taxable income, except that section 1211 shall not apply.

(B) Losses (including losses not compensated for by insurance or otherwise) on the destruction, in whole or in part, theft or seizure, or requisition or condemnation of -

(i) property used in the trade or business, or

(ii) capital assets which are held for more than 1 year and are held in connection with a trade or business or a transaction entered into for profit, shall be treated as losses from a compulsory or involuntary conversion.

(C) In the case of any involuntary conversion (subject to the provisions of this subsection but for this sentence) arising from fire, storm, shipwreck, or other casualty, or from theft, of any -

(i) property used in the trade or business, or

(ii) any capital asset which is held for more than 1 year and is held in connection with a trade or business or a transaction entered into for profit, this subsection shall not apply to such conversion (whether resulting in gain or loss) if during the taxable year the recognized losses from such conversions exceed the recognized gains from such conversions.

(b) Definition of property used in the trade or business

For purposes of this section -

(1) General rule

The term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 1 year, and real property used in the trade or business, held for more than 1 year, which is not -

(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year,

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business,

(C) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by a taxpayer described in paragraph (3) of section 1221, or

(D) a publication of the United States Government (including the Congressional Record) which is received from the United States Government, or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by a taxpayer described in paragraph (5) of section 1221.

(2) Timber, coal, or domestic iron ore

Such term includes timber, coal, and iron ore with respect to which section 631 applies.

(3) Livestock

Such term includes -

(A) cattle and horses, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, and held by him for 24 months or more from the date of acquisition, and

(B) other livestock, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

(4) Unharvested crop

In the case of an unharvested crop on land used in the trade or business and held for more than 1 year, if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted) at the same time and to the same person, the crop shall be considered as "property used in the trade or business."

(c) Recapture of net ordinary losses

(1) In general

The net section 1231 gain for any taxable year shall be treated as ordinary income to the extent such gain does not exceed the non-recaptured net section 1231 losses.

(2) Non-recaptured net section 1231 losses

For purposes of this subsection, the term "non-recaptured net section 1231 losses" means the excess of -

(A) the aggregate amount of the net section 1231 losses for the 5 most recent preceding taxable years beginning after December 31, 1981, over

(B) the portion of such losses taken into account under paragraph (1) for such preceding taxable years.

(3) Net section 1231 gain

For purposes of this subsection, the term "net section 1231 gain" means the excess of -

(A) the section 1231 gains, over

(B) the section 1231 losses.

(4) Net section 1231 loss

For purposes of this subsection, the term "net section 1231 loss" means the excess of -

(A) the section 1231 losses, over

(B) the section 1231 gains.

(5) Special rules

For purposes of determining the amount of the net section 1231 gain or loss for any taxable year, the rules of paragraph (4) of subsection (a) shall apply.

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29 U.S.C. § 1002(2)(A) Plan defined

Except as provided in subparagraph (B), the terms - "employee pension benefit plan" and "pension plan" mean any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund, or program -

(i) provides retirement income to employees, or

(ii) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond, regardless of the method of

calculating the contributions made to the plan, the method of calculating the benefits under the plan or the method of distributing benefits from the plan.

29 U.S.C. § 1002(5) Employer defined

The term "employer" means any person acting directly as an employer, or indirectly in the interest of an employer, in relation to an employee benefit plan; and includes a group or association of employers acting for an employer in such capacity. 29 USC §1002(5).

29 U.S.C. § 1104 Fiduciary duties

(a) Prudent man standard of care

(1) Subject to sections 1103(c) and (d), 1342, and 1344 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and -

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter and subchapter III of this chapter.

(2) In the case of an eligible individual account plan (as

defined in section 1107(d)(3) of this title), the diversification requirement of paragraph (1)(C) and the prudence requirement (only to the extent that it requires diversification) of paragraph (1)(B) is not violated by acquisition or holding of qualifying employer real property or qualifying employer securities (as defined in section 1107(d)(4) and (5) of this title).

(b) Indicia of ownership of assets outside jurisdiction of district courts

Except as authorized by the Secretary by regulations, no fiduciary may maintain the indicia of ownership of any assets of a plan outside the jurisdiction of the district courts of the United States.

(c) Control over assets by participant or beneficiary

In the case of a pension plan which provides for individual accounts and permits a participant or beneficiary to exercise control over the assets in his account, if a participant or beneficiary exercises control over the assets in his account (as determined under regulations of the Secretary) -

(1) such participant or beneficiary shall not be deemed to be a fiduciary by reason of such exercise, and

(2) no person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant's or beneficiary's exercise of control.

(d) Plan terminations

(1) If, in connection with the termination of a pension plan which is a single-employer plan, there is an election to establish or maintain a qualified replacement plan, or to increase benefits, as provided under section 4980(d) of title 26, a fiduciary shall discharge the fiduciary's duties under this subchapter and subchapter III of this chapter in accordance with the following requirements:

(A) In the case of a fiduciary of the terminated plan, any requirement -

(i) under section 4980(d)(2)(B) of title 26 with respect to the transfer of assets from the terminated plan to a qualified replacement plan, and

(ii) under section 4980(d)(2)(B)(ii) or 4980(d)(3) of title 26 with respect to any increase in benefits under the terminated plan.

(B) In the case of a fiduciary of a qualified replacement plan, any requirement -

(i) under section 4980(d)(2)(A) of title 26 with respect to participation in the qualified replacement plan of active participants in the terminated plan,

(ii) under section 4980(d)(2)(B) of title 26 with respect to the receipt of assets from the terminated plan, and

(iii) under section 4980(d)(2)(C) of title 26 with respect to the allocation of assets to participants of the qualified replacement plan.

(2) For purposes of this subsection -

(A) any term used in this subsection which is also used in section 4980(d) of title 26 shall have the same meaning as when used in such section, and

(B) any reference in this subsection to title 26 shall be a reference to title 26 as in effect immediately after the enactment of the Omnibus Budget Reconciliation Act of 1990.

APPENDIX E: HUGHES NON-BARGAINING RETIREMENT PLAN

Article II: Eligibility (Ex. 3-C, PP. 19-22)

{19} ARTICLE II

ELIGIBILITY

Section 2.1 -Requirements for Participation

(a) Effective January 1, 1980 any person who was a Participant in the Hughes Retirement Plan on December 31, 1979 and not employed in a bargaining unit covered by a collective bargaining agreement shall remain a Participant until Section 2.4 or 2.5 applies to him.

(b) Any other Employee who

(i) had not attained the age of sixty—four years and six months on last becoming an Employee, and

(ii) has completed either

a a twelve—month period commencing with

1 his first Hour of Service since the date The was hired as an Employee of his Company (whether or not then a Company), or

2 his Anniversary Date

in which period he had completed one thousand (T,000) or more Hours of Service, or

b twelve months of Company Service, and

(iii) is not an Employee in a bargaining unit covered by a collective bargaining agreement with respect to which {20} retirement benefits were the subject of good faith bargaining (unless such agreement provides for coverage hereunder of Employees in such unit), and

(iv) is not a Sales Representative of Theta Cable of California, and

(v) is on the United States payroll of his Company (as maintained by such Company in accordance with its established practice), and

(vi) complies with the requirements of Section 2.3,

shall become a Participant after 1979, effective as of the first Monday of the calendar month coincident with or next following his satisfaction of such requirements.

(c) Any Participant whose participation is terminated by a Separation from the Service under Section 2.4 shall again become a Participant upon again becoming an Employee and complying with the requirements of paragraphs (iii)--(vi), inclusive, of subsection (b). There shall be no duplication of any previously Accrued Benefits by reason of a Participant's readmission to the Plan.

Section 2.2 - Notice of Eligibility

The Administrator shall give reasonable advance written notice to the Employees of their prospective eligibility to become Participants.

Section 2.3 - Application to Participate

The Administrator shall furnish each eligible Employee with a form of application for participation in which, as a condition precedent to participation, he shall state:

(a) his request for participation in the Plan;

(b) his name, date of birth, name and date of birth of spouse, and other relevant information;

(c) his consent that he, his Beneficiaries, Contingent Annuitants, successors in interest, and all persons claiming under him, shall be bound by the statements contained therein and the provisions of the Plan as they now exist, and as they may be amended from time to time, to the extent consistent with applicable law, and

(d) his agreement to make Participant Contributions under Section 3.4 in accordance with Section 3.5 and his {21} authorization to his Company to withhold such amounts from his Compensation and transmit the same to the Trustee in accordance with Sections 3.5 and 3.6.

Section 2.4 - Termination of Participation

A Participant shall cease to be a Participant and shall become entitled to Benefits, if any, in accordance with Article IV, upon his Separation from the Service.

Section 2.5—Suspension During Continuous Service

A Participant may suspend his participation in the Plan during his Continuous Service at any time by giving such advance written notice to the Administrator as is required under the Rules of the Plan that he declines to make contributions under Section 3.4 for a period of twelve calendar months and thereafter until he again complies with Section 2.3, which notice shall be effective and irrevocable in accordance with its terms upon receipt by the Administrator.

Section 2.6 — Forfeitures

If a Participant has a Separation from the Service for any reason prior to his acquisition of a fully Vested Retirement Benefit, the unvested portion of his Accrued Benefit Derived from Company Contributions shall be forfeited at the earliest of

(a) if he then has less than five Years of Vesting Schedule Service, that date when the number of his consecutive Break in Service Years equals five,

(b) if he has then had one or more Break in Service Years not followed by a Year of Service, immediately preceding his sixty—fifth birthday, or

(c) if he then has less than five Years of Vesting Schedule Service, his withdrawal of Participant Contributions under Section 3.8(a) provided that any such unvested portion shall be restored subject to subsequent forfeiture under this Section, if, before subsection. (a) applies, he restores such withdrawn Contributions with interest under Section 3.8(b).

Section 2.7 - Inactive Status

(a) A Participant who is transferred directly to a position or classification with the Company which:

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(i) fails to meet the requirements of Section 2.1(b)(iv) or (v) shall thereupon become a Participant on inactive status and shall not thereafter make contributions under Article III; or

(ii) fails to meet the requirements of Section 2.1(b)(iii) shall on the first day of the Accounting Month coinciding with or following such transfer become a Participant on inactive status and shall not thereafter make contributions under Article III.

(b) All provisions of the Plan, including Article IV, will continue to apply to a Participant on inactive status.

(c) If a Participant on inactive status is retransferred to a position or classification which:

(i) meets the requirements of Section 2.1(b)(iv) and (v), he shall thereupon be restored to active status and may resume making contributions under Article III, or

(ii) meets the requirements of Section 2.1(b)(iii) he shall on the first day of the Accounting Month coinciding with or following such transfer be restored to active status and may resume making contributions under Article III.